

**TECHNICAL EXPLANATION OF THE  
REVENUE PROVISIONS CONTAINED IN THE  
“AMERICAN JOBS AND CLOSING TAX LOOPHOLES ACT OF 2010,”  
FOR CONSIDERATION ON THE FLOOR OF  
THE HOUSE OF REPRESENTATIVES**

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions contained in the “American Jobs and Closing Tax Loopholes Act of 2010,” for consideration on the floor of the House of Representatives. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the “American Jobs and Closing Tax Loopholes Act of 2010,” for consideration on the floor of the House of Representatives*, (JCX-29-10), May 28, 2010. This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

## **TITLE I – INFRASTRUCTURE INCENTIVES**

### **A. Extension of Build America Bonds (sec. 101 of the bill and sec. 54AA of the Code)**

#### **Present Law**

#### **Build America Bonds**

Section 54AA, added to the Code by the American Recovery and Reinvestment Act of 2009 (“ARRA”),<sup>2</sup> permits an issuer to elect to have an otherwise tax-exempt bond, issued prior to January 1, 2011, treated as a “Build America Bond.”<sup>3</sup> 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 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,<sup>4</sup> and the issuer makes an irrevocable election to have the rules in section 54AA apply.<sup>5</sup> 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.<sup>6</sup> 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;<sup>7</sup> the yield on a direct-pay Build America Bond is reduced by the payment made pursuant to section 6431.<sup>8</sup> A Build America

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<sup>2</sup> Pub. L. No. 111-5.

<sup>3</sup> Sec. 54AA.

<sup>4</sup> Thus, where a bond otherwise satisfies all of the requirements under section 103 to be treated as a tax-exempt 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).

<sup>5</sup> 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. Notice 2009-26, 2009-16 I.R.B. 833.

<sup>6</sup> 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.

<sup>7</sup> Sec. 54AA(d)(2)(B).

<sup>8</sup> Sec. 6431(c).



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.<sup>9</sup>

### 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.<sup>10</sup> 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.<sup>11</sup> The sum of the accrued credits is allowed against regular and alternative minimum tax; unused credit may be carried forward to succeeding taxable years.<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup>

### 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.<sup>15</sup> 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.<sup>16</sup> Direct-pay Build America Bonds may not be issued to refinance capital

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<sup>9</sup> Sec. 54AA(d)(2)(C).

<sup>10</sup> 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)).

<sup>11</sup> Sec. 54AA(e).

<sup>12</sup> Sec. 54AA(c).

<sup>13</sup> Sec. 54AA(f).

<sup>14</sup> Ibid.

<sup>15</sup> Sec. 54AA(g)(1). OID is not treated as a payment of interest for purposes of calculating the refundable credit under the provision.

<sup>16</sup> Sec. 54AA(g). The scope of eligible capital expenditures for Build America Bonds that are qualified bonds under section 54AA(g)(2) generally is intended to be limited to capital expenditures for tangible real or personal property (for example, costs incurred to acquire, construct or improve land, buildings, and equipment) and other similar costs, including those as may be further provided by the Treasury Department in regulations. An example of an eligible capital expenditure would include expenditures made for the purchase of fiber-optic cable to provide municipal broadband service. Eligible capital expenditures for purposes of section 54AA generally do not include expenditures for investment property (as defined for arbitrage purposes in section 148(b)(2)) or for other capitalizable costs of financial assets attributable to prepayments for goods or services (for example, prepayments for electricity or gas).

expenditures in “refunding issues” (as defined in Treas. Reg. sec. 1.150-1).<sup>17</sup> Direct-pay Build 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.<sup>18</sup>

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.<sup>19</sup> In lieu of payment to the issuer, the payment may be made to a person making interest payments on behalf of the issuer.<sup>20</sup>

### **Explanation of Provision**

The provision extends both types of Build America Bonds through December 31, 2012. For direct-pay Build America Bonds issued in 2011, it provides for a payment to the issuer equal to 32 percent of each interest payment made under such bond. For direct-pay Build America Bonds issued in 2012, the rate for payments to issuers is reduced to 30 percent of each interest payment.

In addition, the provision expands the definition of qualified bond to include a bond issued to effect a current refunding (or series of current refundings) of qualified bonds, provided that (1) the average maturity date of the issue of which the refunding bond is a part is not later than the average maturity date of the bonds to be refunded by such issue, (2) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and (3) the refunded bond is redeemed not later than 90 days after the date of the issuance of the refunding bond. For a direct-pay Build America Bond issued to refund another issue of direct-pay Build America Bonds, the provision provides that the payment to the issuer shall be at the lowest rate provided in section 6431 (i.e., 30 percent under the provision).

The provision also reaffirms that Build America Bonds may be used for capital expenditures for levees and other flood control projects.

### **Effective Date**

The provision is effective as of the date of enactment.

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<sup>17</sup> 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.

<sup>18</sup> 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. Notice 2009-26, 2009-16 I.R.B. 833.

<sup>19</sup> Sec. 6431.

<sup>20</sup> Sec. 6431(b).

**B. Exempt-Facility Bonds for Sewage and Water Supply Facilities**  
**(sec. 102 of the bill and sec. 146 of the Code)**

**Present Law**

**In general**

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Interest on State or local bonds issued to finance activities of private persons is taxable unless issued for certain purposes permitted by the Code (“qualified private activity bonds”).<sup>21</sup>

The definition of a qualified private activity bond includes exempt facility bonds, qualified mortgage, veterans’ mortgage, small issue, redevelopment, 501(c)(3), and student loan bonds.<sup>22</sup> The definition of an exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); low-income residential rental property; 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/sustainable design projects, qualified hazardous waste facilities, and qualified highway or surface freight transfer facilities.<sup>23</sup> A facility for the furnishing of water will qualify as an exempt facility if: the water is or will be made available to members of the general public (including electric, industrial, agricultural, or commercial users); and either the facilities are (1) operated by a governmental unit or (2) the rates for the furnishing or sale of the water have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.<sup>24</sup>

Issuance of most qualified private activity bonds is subject (in whole or in part) to annual State volume limitations (“State volume cap”).<sup>25</sup> For calendar year 2010, the State volume cap, which is indexed for inflation, equals \$90 per resident of the State, or \$273,775,000, if greater.<sup>26</sup>

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<sup>21</sup> Sec. 103(b)(1).

<sup>22</sup> Sec. 141(e).

<sup>23</sup> Sec. 142(a).

<sup>24</sup> Sec. 142(e).

<sup>25</sup> Sec. 146.

<sup>26</sup> Rev. Proc. 2009-50, 2009-45 I.R.B. 617 (November 9, 2009).

Exceptions from the State volume cap are provided for bonds issued for certain government-owned facilities (airports, ports, certain high-speed intercity rail, and solid waste disposal) and bonds which are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, qualified green building/sustainable design projects, and qualified highway or surface freight transfer facility bonds).

If an issuing authority's State volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the authority generally may elect to treat all (or any portion) of the excess as a carryforward for one or more specified "carryforward purposes." The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean one of four purposes: issuing exempt facility bonds; issuing qualified mortgage bonds or mortgage credit certificates; issuing qualified student loan bonds; and issuing qualified redevelopment bonds.<sup>27</sup> A carryforward of unused State volume cap is valid for three years.

Many States have State revolving fund programs ("SRFs") to finance wastewater and drinking water projects. SRFs are pools of capital dedicated to financing public infrastructure formed through Federal and state contributions. SRFs use Federal grants to make loans to local governments to finance the construction of water facilities and to establish debt service reserve funds for bonds the proceeds of which are so be used to make such loans. Although present law generally prohibits the Federal guarantee of tax-exempt bonds,<sup>28</sup> the IRS has ruled that States may use Federal grants to fund debt service reserve funds for tax-exempt bonds issued to finance SRF loans without affecting the tax-exempt status of such bonds.<sup>29</sup>

### **Indian tribal governments**

Under present law, gross income does not include interest on State or local bonds.<sup>30</sup> State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or that 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 these purposes, the term "nongovernmental person" includes the Federal government and all other individuals and entities other than States or local

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<sup>27</sup> Sec. 146(f)(5).

<sup>28</sup> Sec. 149(b).

<sup>29</sup> Notice 88-54, 1988-1 C.B. 539.

<sup>30</sup> Sec. 103.

governments.<sup>31</sup> Interest on private activity bonds is taxable, unless the bonds are issued for certain purposes permitted by the Code and other requirements are met.<sup>32</sup>

Although not States or subdivisions of States, Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.<sup>33</sup> Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. Under section 7871(c), tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions.<sup>34</sup> The term essential governmental function does not include any function that is not customarily performed by State and local governments with general taxing powers. Section 7871(c) further prohibits Indian tribal governments from issuing tax-exempt private activity bonds (as defined in section 141(a) of the Code) with the exception of certain bonds for manufacturing facilities.

### **Explanation of Provision**

The provision provides that tax-exempt bonds issued to finance privately used or operated facilities for the furnishing of water or sewage facilities are not subject to the State volume caps.<sup>35</sup>

Also, the provision allows Indian tribal governments to issue tax-exempt private activity bonds for two additional types of facilities. These new facilities are facilities for the furnishing of water<sup>36</sup> and sewerage facilities.<sup>37</sup> These bonds are not subject to the private activity bond volume limitation, nor the essential government function test.

### **Effective Date**

The provision is effective for bonds issued after the date of enactment.

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<sup>31</sup> Sec. 141(b)(6); Treas. Reg. sec. 1.141-1(b).

<sup>32</sup> Secs. 103(b)(1) and 141.

<sup>33</sup> Sec. 7871.

<sup>34</sup> Sec. 7871(c).

<sup>35</sup> To the extent an issuer previously designated facilities for the furnishing of water or sewerage facilities when the issuer elected to carry-forward unused volume cap, the issuer shall be allowed to designate another carry-forward purpose in a time and manner provided under guidance from the Secretary of the Treasury.

<sup>36</sup> Sec. 142(a)(4).

<sup>37</sup> Sec. 142(a)(5).

**C. Extension of Exemption from Alternative Minimum Tax Treatment  
for Certain Tax-Exempt Bonds  
(sec. 103 of the bill and sec. 57 of the Code)**

**Present Law**

Present law imposes an alternative minimum tax (“AMT”) on individuals and corporations. AMT is the amount by which the tentative minimum tax exceeds the regular income tax. The tentative minimum tax is computed based upon a taxpayer’s alternative minimum taxable income (“AMTI”). AMTI is the taxpayer’s taxable income modified to take into account certain preferences and adjustments. One of the preference items is tax-exempt interest on certain tax-exempt bonds issued for private activities (sec. 57(a)(5)). Also, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75 percent of items, including tax-exempt interest, that are excluded from taxable income but included in the corporation’s earnings and profits (sec. 56(g)(4)(B)).

The American Recovery and Reinvestment Act of 2009 provided that tax-exempt interest on private activity bonds issued in 2009 and 2010 is not an item of tax preference for purposes of the alternative minimum tax and interest on tax exempt bonds issued in 2009 and 2010 is not included in the corporate adjustment based on current earnings. For these purposes, a refunding bond is treated as issued on the date of the issuance of the refunded bond (or in the case of a series of refundings, the original bond).

The Act also provided that tax-exempt interest on private activity bonds issued in 2009 and 2010 to currently refund a private activity bond issued after December 31, 2003, and before January 1, 2009, is not an item of tax preference for purposes of the alternative minimum tax. Also, tax-exempt interest on bonds issued in 2009 and 2010 to currently refund a bond issued after December 31, 2003, and before January 1, 2009, is not included in the corporate adjustment based on current earnings.

**Explanation of Provision**

The provision extends the minimum tax treatment of interest on tax-exempt bonds provided by the American Recovery and Reinvestment Act of 2009 to bonds issued in 2011.

**Effective Date**

The provision applies to interest on bonds issued after December 31, 2010.

**D. Extension and Additional Allocations of Recovery Zone Bond Authority**  
**(sec. 104 of the bill and sec. 1400U-2-1400U-3 of the Code)**

**Present Law**

**In general**

Issuers may issue recovery zone economic development bonds and recovery zone facility bonds with respect to a recovery zone. A recovery zone is (1) any area designated by an issuer as having significant poverty, unemployment, rate of home foreclosures, or general distress; (2) any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, or (3) any area for which a designation as an empowerment zone or renewal community is in effect.

There is a national recovery zone economic development bond limitation of \$10 billion. In addition, there is a separate national recovery zone facility bond limitation of \$15 billion. Present law requires that the Secretary allocate these bond limitations among the States in the proportion that each State's employment decline bears to the national decline in employment (the aggregate 2008 State employment declines for all States). The allocations are adjusted to the extent necessary to ensure that no State receives less than 0.9 percent of each recovery zone bond limitation.

In turn, each State is to reallocate its allocation among the counties (parishes) and large municipalities in such State in the proportion that each such county or municipality's 2008 employment decline bears to the aggregate employment declines for all counties and municipalities in such State. In calculating the local employment decline with respect to a county, the portion of such decline attributable to a large municipality is disregarded for purposes of determining the county's portion of the State employment decline and is attributable to the large municipality only.

The "2008 State employment decline" means, with respect to any State, the excess (if any) of (i) the number of individuals employed in such State as determined for December 2007, over (ii) the number of individuals employed in such State as determined for December 2008. The term "large municipality" means a municipality with a population of more than 100,000.

**Recovery zone economic development bonds**

A recovery zone economic development bond is a Build America Bond (a type of taxable governmental bond) that entitles the issuer of such bonds to receive a refundable tax credit (payment) equal to 45 percent of the interest payable on an interest payment date.

A recovery zone economic development bond is a Build America Bond issued as part of an issue if 100 percent of the available project proceeds of such issue are to be used for one or more qualified economic development purposes and the issuer designates such bond as a recovery zone economic development bond. A qualified economic development purpose means expenditures for purposes of promoting development or other economic activity in a recovery zone, including (1) capital expenditures paid or incurred with respect to property located in such

zone, (2) expenditures for public infrastructure and construction of public facilities located in a recovery zone and (3) expenditures for job training and educational programs.

The aggregate face amount of bonds which may be designated by any issuer cannot exceed the amount of the recovery zone economic development bond limitation allocated to such issuer. Recovery zone economic development bonds must be issued before January 1, 2011.

### **Recovery zone facility bonds**

A recovery zone facility bond is any bond issued as part of an issue if: (1) 95 percent or more of the net proceeds of such issue are to be used for recovery zone property and (2) such bond is issued before January 1, 2011, and (3) the issuer designates such bond as a recovery zone facility bond. The aggregate face amount of bonds which may be designated by any issuer cannot exceed the amount of the recovery zone facility bond limitation allocated to such issuer.

Under the provision, the term “recovery zone property” means any property subject to depreciation to which section 168 applies (or would apply but for section 179) if (1) such property was acquired by the taxpayer by purchase after the date on which the designation of the recovery zone took effect; (2) the original use of such property in the recovery zone commences with the taxpayer; and (3) substantially all of the use of such property is in the recovery zone and is in the active conduct of a qualified business by the taxpayer in such zone. The term “qualified business” means any trade or business except that the rental to others of real property located in a recovery zone shall be treated as a qualified business only if the property is not residential rental property (as defined in section 168(e)(2)) and does not include any trade or business consisting of the operation of any facility described in section 144(c)(6)(B) (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale of alcoholic beverages for consumption off premises).

Subject to the following exceptions and modifications, issuance of recovery zone facility bonds is subject to the general rules applicable to issuance of qualified private activity bonds:

1. Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);
2. The restriction on acquisition of existing property does not apply (sec. 147(d));

### **Explanation of Provision**

The provision extends for one additional year the period for issuing recovery zone economic development bonds and recovery zone facility bonds (through December 31, 2011).

The provision provides for a second allocation of \$10 billion of recovery zone economic development bonds and \$15 billion of recovery zone facility bonds. This second allocation is made in the proportion that each State’s 2009 unemployment number bears to the aggregate of the 2009 unemployment numbers for all States. The second round of allocations is adjusted to the extent necessary to ensure that no State receives less than 0.9 percent of each recovery zone bond limitation, before the reduction discussed below.



Similar to present law, each State is to reallocate its allocation among the counties (parishes) and large municipalities in such State in the proportion that each such county or municipality's 2009 unemployment number bears to the aggregate 2009 unemployment number for all counties and municipalities in such State. In the case of any large municipality, any portion of which is in a county, such portion is treated as part of the municipality and not part of the county.

A State is required to reduce, but not below zero, each allocation to a county or large municipality by the amount of the first (present law) recovery zone economic development bond allocation. Similarly, each county or large municipality's second allocation of recovery zone facility bond allocation is reduced, but not below zero, by the amount of the first recovery zone facility bond allocation. These reductions are made without regard to any waiver of allocation made by the county or large municipality. For purposes of the limitations on the amount of bonds that may be designated, any amount of the national allocation that is not allocated by a State to a county or large municipality as a result of such reduction shall be treated as not allocated to any issuer, including the State itself.

Under present law and under the bill, a county or municipality may waive any portion of an allocation made to it. The provision further provides that a county or municipality is deemed to waive back to the State the portion of an allocation made to a county or municipality that is not used to issue bonds by May 1, 2011. This rule applies to all allocations, including the first round of allocations made in 2009. No negative inference is intended regarding State laws enacted prior to the date of enactment which deem a county or municipality's allocation waived before May 1, 2011. Any waived allocation may be used or reallocated by the State.

The term "2009 unemployment number" means, with respect to any State, county or municipality, the number of individuals in such State, county, or municipality who were determined to be unemployed by the Bureau of Labor Statistics for December 2009.

#### **Effective Date**

The provision is effective on the date of enactment.

**E. Allow the New Markets Tax Credit for Purposes of the Alternative Minimum Tax  
(sec. 105 of the bill and sec. 38 of the Code)**

**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.<sup>38</sup> 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 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). Credits not allowed may be carried back one year and carried over for up to 20 years.

**Explanation of Provision**

The provision treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the new markets tax credit.

The provision is not effective for qualified equity investments made after December 31, 2011.

**Effective Date**

The provision applies to qualified equity investments (as defined in section 45D(b)) initially made after March 15, 2010.

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<sup>38</sup> Sec. 55(a).

**F. Extension of Tax-Exempt Eligibility for Loans Guaranteed  
by Federal Home Loan Banks  
(sec. 106 of the bill and sec. 149 of the Code)**

**Present Law**

**In general**

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. However, the exclusion generally does not apply to State and local bonds that are Federally guaranteed. Under present law, a bond is Federally guaranteed if: (1) the payment of principal or interest with respect to such bond is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof); (2) such bond is issued as part of an issue and five percent or more of the proceeds of such issue is to be (a) used in making loans the payment of principal or interest with respect to which is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or (b) invested directly or indirectly in Federally insured deposits or accounts; or (3) the payment of principal or interest on such bond is otherwise indirectly guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof).

The Federal guarantee restriction was enacted in 1984 with certain exceptions for certain guarantee programs in existence at that time. The exceptions include guarantees by: the Federal Housing Administration; the Department of Veterans' Affairs; the Federal National Mortgage Association; the Federal Home Loan Mortgage Association; the Government National Mortgage Association; the Student Loan Marketing Association; and the Bonneville Power Authority. The exception also includes guarantees for certain housing programs. These are: (a) private activity bonds for a qualified residential rental project or a housing program obligation under section 11(b) of the United States Housing Act of 1937; (b) a qualified mortgage bond; or (c) a qualified veterans' mortgage bond.

**Special rule for the Federal Home Loan Bank**

Under a special rule, bonds issued by State and local governments are not treated as Federally guaranteed by reason of any guarantee provided by any Federal Home Loan Bank of a bond issued after the date of enactment and before January 1, 2011, if such bank made a guarantee of such bond in connection with such issuance.

This exception to the Federal guarantee prohibition does not apply to any guarantee by a Federal home loan bank unless such bank meets safety and soundness collateral requirements for such guarantees which are at least as stringent as the regulatory requirements for guarantees by Federal home loan banks as in effect on April 9, 2008.

**Explanation of Provision**

The provision provides a one-year extension (through December 31, 2011) of the special rule for Federal Home Loan Bank.

**Effective Date**

The provision applies to guarantees made after December 31, 2010.

**G. Extension of Temporary Modification of Small Issuer Rules for Allocation  
of Tax-Exempt Interest Expense by Financial Institutions  
(sec. 107 of the bill and sec. 265 of the Code)**

**Present Law**

**In general**

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax.<sup>39</sup> In general, an interest deduction is disallowed only if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations; a determination of the taxpayer's purpose in borrowing funds is made based on all of the facts and circumstances.<sup>40</sup>

**Exception for certain obligations of qualified small issuers**

The general rule in section 265(b), denying financial institutions' interest expense deductions allocable to tax-exempt obligations, does not apply to "qualified tax-exempt obligations."<sup>41</sup> Instead, as discussed in the next section, only 20 percent of the interest expense allocable to "qualified tax-exempt obligations" is disallowed.<sup>42</sup> A "qualified tax-exempt obligation" is a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond, and (3) is designated by the issuer as qualifying for the exception from the general rule of section 265(b).

A "qualified small issuer" is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be \$10 million or less.<sup>43</sup> The Code specifies the circumstances under which an issuer and all subordinate entities are aggregated.<sup>44</sup> For purposes of the \$10 million limitation, an issuer and all entities that issue obligations on behalf of such issuer are treated as one issuer. All obligations issued by a subordinate entity are treated as being issued by the entity to which it is subordinate. An entity formed (or availed of) to avoid the \$10 million limitation and all entities benefiting from the device are treated as one issuer.

Composite issues (i.e., combined issues of bonds for different entities) qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as

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<sup>39</sup> Sec. 265(a).

<sup>40</sup> See Rev. Proc. 72-18, 1972-1 C.B. 740.

<sup>41</sup> Sec. 265(b)(3).

<sup>42</sup> Secs. 265(b)(3)(A), 291(a)(3) and 291(e)(1).

<sup>43</sup> Sec. 265(b)(3)(C).

<sup>44</sup> Sec. 265(b)(3)(E).

a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue).<sup>45</sup> Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed \$10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than \$10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

#### Treatment of financial institution preference items

Section 291(a)(3) reduces by 20 percent the amount allowable as a deduction with respect to any financial institution preference item. Financial institution preference items include interest on debt to carry tax-exempt obligations acquired after December 31, 1982, and before August 8, 1986.<sup>46</sup> Section 265(b)(3) treats qualified tax-exempt obligations as if they were acquired on August 7, 1986. As a result, the amount allowable as a deduction by a financial institution with respect to interest incurred to carry a qualified tax-exempt obligation is reduced by 20 percent.

#### **Special rule for 2009 and 2010**

##### Modifications to qualified small issuer exception

With respect to tax-exempt obligations issued during 2009 and 2010, the special rule increases from \$10 million to \$30 million the annual limit for qualified small issuers.

In addition, in the case of “qualified financing issue” issued in 2009 or 2010, the special rule applies the \$30 million annual volume limitation at the borrower level (rather than at the level of the pooled financing issuer). Thus, for the purpose of applying the requirements of the section 265(b)(3) qualified small issuer exception, the portion of the proceeds of a qualified financing issue that are loaned to a “qualified borrower” that participates in the issue are treated as a separate issue with respect to which the qualified borrower is deemed to be the issuer.

A “qualified financing issue” is any composite, pooled or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to one or more ultimate borrowers all of whom are qualified borrowers. A “qualified borrower” means (1) a State or political subdivision of a State or (2) an organization described in section 501(c)(3) and exempt from tax under section 501(a). Thus, for example, a \$100 million pooled financing issue that was issued in 2009 could qualify for the section 265(b)(3) exception if the proceeds of such issue were used to make four equal loans of \$25 million to four qualified borrowers. However, if (1) more than \$30 million were loaned to any qualified borrower, (2) any borrower were not a qualified borrower, or (3) any borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to such borrower, fail to meet any of the other requirements

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<sup>45</sup> Sec. 265(b)(3)(F).

<sup>46</sup> Sec. 291(e)(1).

of section 265(b)(3), the entire \$100 million pooled financing issue would fail to qualify for the exception.

For purposes of determining whether an issuer meets the requirements of the small issuer exception, qualified 501(c)(3) bonds issued in 2009 or 2010 are treated as if they were issued by the 501(c)(3) organization for whose benefit they were issued (and not by the actual issuer of such bonds). In addition, in the case of an organization described in section 501(c)(3) and exempt from taxation under section 501(a), requirements for “qualified financing issues” shall be applied as if the section 501(c)(3) organization were the issuer. Thus, in any event, an organization described in section 501(c)(3) and exempt from taxation under section 501(a) shall be limited to the \$30 million per issuer cap for qualified tax exempt obligations described in section 265(b)(3).

### **Explanation of Provision**

The provision extends the temporary modifications to the qualified small issuer exception for one additional year (through 2011).

### **Effective Date**

The provision is effective for obligations issued after December 31, 2010.

## **TITLE II – EXTENSION OF EXPIRING PROVISIONS**

### **A. Energy**

#### **1. Alternative motor vehicle credit for heavy hybrids (sec. 201 of the bill and sec. 30B of the Code)**

##### **Present Law**

##### **In general**

A credit is available for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the taxable year.<sup>47</sup> In general, the credit amount varies depending upon the type of technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005. The credit terminates after 2009, 2010, or 2014, depending on the type of vehicle.

In general, the credit is allowed to the vehicle owner, including the lessor of a vehicle subject to a lease. If the use of the vehicle is described in paragraphs (3) or (4) of section 50(b) (relating to use by tax-exempt organizations, governments, and 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. The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as a portion of the general business credit.

##### **Hybrid vehicles**

##### **Qualified hybrid vehicles**

A qualified hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy that include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). A qualified hybrid vehicle must be placed in service before January 1, 2011 (January 1, 2010 in the case of a hybrid vehicle weighing more than 8,500 pounds).

##### **Hybrid vehicles that are automobiles and light trucks**

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: (1) a fuel economy credit amount that varies between \$400 and \$2,400 depending on the rated fuel economy of the vehicle compared to a 2002 model year standard and (2) a conservation credit of

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<sup>47</sup> Sec. 30B.



between \$250 and \$1,000 based on the estimated lifetime fuel savings of the qualified vehicle compared to a comparable 2002 model year vehicle that is powered solely by a gasoline or diesel internal combustion engine. A qualified hybrid automobile or light truck must have a maximum available power<sup>48</sup> from the rechargeable energy storage system of at least four percent. In addition, the vehicle must meet or exceed certain Environmental Protection Agency (“EPA”) emissions standards.

There is a 60,000 vehicle limit on the number of passenger and light truck qualified hybrid vehicles sold by each manufacturer of such vehicles that are eligible for the credit.<sup>49</sup>

#### Hybrid vehicles that are medium and heavy trucks

In the case of a qualified hybrid vehicle weighing more than 8,500 pounds, the amount of credit is determined by the estimated increase in fuel economy and the incremental cost of the hybrid vehicle relative to a vehicle powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size, and use. For a vehicle that achieves a fuel economy increase of at least 30 percent but less than 40 percent, the credit is equal to 20 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of at least 40 percent but less than 50 percent, the credit is equal to 30 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

The credit is subject to certain maximum applicable incremental cost amounts. For a qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds, the maximum allowable incremental cost amount is \$7,500. For a qualified hybrid vehicle weighing more than 14,000 pounds but not more than 26,000 pounds, the maximum allowable incremental cost amount is \$15,000. For a qualified hybrid vehicle weighing more than 26,000 pounds, the maximum allowable incremental cost amount is \$30,000.

A qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualified hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.<sup>50</sup>

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<sup>48</sup> For hybrid passenger vehicles and light trucks, the term “maximum available power” means the maximum power available from the rechargeable energy storage system, during a standard 10 second pulse power or equivalent test, divided by such maximum power and the SAE net power of the heat engine. Sec. 30B(d)(3)(C)(i).

<sup>49</sup> Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th hybrid and advanced lean burn technology vehicle sale occurring after December 31, 2005. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

<sup>50</sup> In the case of such heavy-duty hybrid motor vehicles, the percentage of maximum available power is computed by dividing the maximum power available from the rechargeable energy storage system during a standard 10-second pulse power test, divided by the vehicle’s total traction power. A vehicle’s total traction power is the sum

### **Explanation of Provision**

The provision extends for one year the credit available to hybrid vehicles that weigh more than 8,500 pounds.

### **Effective Date**

The provision is effective for property purchased after December 31, 2009.

## **2. Incentives for biodiesel and renewable diesel (sec. 202 of the bill and secs. 40A, 6426 and 6427 of the Code)**

### **Present Law**

#### **Biodiesel**

The Code provides an income tax credit for biodiesel fuels (the “biodiesel fuels credit”).<sup>51</sup> The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2009.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the EPA under section 211 of the Clean Air Act (42 U.S.C. sec. 7545) and (2) the requirements of the American Society of Testing and Materials (“ASTM”) D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, camelina, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

#### **Biodiesel mixture credit**

The biodiesel mixture credit is \$1.00 for each gallon of biodiesel (including agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer

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of the peak power from the rechargeable energy storage system and the heat (e.g., internal combustion or diesel) engine’s peak power. If the rechargeable energy storage system is the sole means by which the vehicle can be driven, then the total traction power is the peak power of the rechargeable energy storage system.

<sup>51</sup> Sec. 40A.

producing such mixture to any person for use as a fuel, or (2) used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Per IRS guidance a mixture need only contain 1/10th of one percent of diesel fuel to be a qualified mixture.<sup>52</sup> Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

#### Biodiesel credit (B-100)

The biodiesel credit is \$1.00 for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle.

#### Small agri-biodiesel producer credit

The Code provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel fuel mixture credits. The credit is a 10-cents-per-gallon credit for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

#### Biodiesel mixture excise tax credit

The Code also provides an excise tax credit for biodiesel mixtures.<sup>53</sup> The credit is \$1.00 for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.<sup>54</sup>

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<sup>52</sup> Notice 2005-62, I.R.B. 2005-35, 443 (2005). "A biodiesel mixture is a mixture of biodiesel and diesel fuel containing at least 0.1 percent (by volume) of diesel fuel. Thus, for example, a mixture of 999 gallons of biodiesel and 1 gallon of diesel fuel is a biodiesel mixture." Ibid.

<sup>53</sup> Sec. 6426(c).

<sup>54</sup> Sec. 6426(c)(4).

The credit is not available for any sale or use for any period after December 31, 2009. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

#### Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.<sup>55</sup> The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels. To the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, if the person has no section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2009.

#### Renewable diesel

"Renewable diesel" is liquid fuel that (1) is derived from biomass (as defined in section 45K(c)(3)), (2) meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act, and (3) meets the requirements of the ASTM D975 or D396, or equivalent standard established by the Secretary. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces. Renewable diesel also includes fuel derived from biomass that meets the requirements of a Department of Defense specification for military jet fuel or an ASTM for aviation turbine fuel.

For purposes of the Code, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.<sup>56</sup> The incentive for renewable diesel is \$1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2009.

#### Explanation of Provision

The provision extends the income tax credit, excise tax credit and payment provisions for biodiesel and renewable diesel for one additional year (through December 31, 2010).

#### Effective Date

The provision is effective for sales and uses after December 31, 2009.

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<sup>55</sup> Sec. 6427(e).

<sup>56</sup> Secs. 40A(f), 6426(c), and 6427(e).

### **3. Credit for electricity produced at certain open-loop biomass facilities (sec. 203 of the bill and sec. 45 of the Code)**

#### **Present Law**

##### **In general**

An income tax credit is allowed for the production of electricity from biomass at qualified open-loop biomass facilities. The credit rate is 1.1 cents per kilowatt-hour of electricity produced in 2009 and is adjusted for inflation. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person. A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. The credit is a component of the general business credit, and excess credits may be carried back one year and forward up to 20 years.

##### **Credit period**

A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. However, for qualified open-loop biomass facilities (other than facilities described in section 45(d)(3)(A)(i) that use agricultural livestock waste nutrients) placed in service before October 22, 2004, the credit is available for a five-year period commencing on January 1, 2005.

##### **Credit phase-out**

The amount of credit a taxpayer may claim is phased out as the market price of electricity exceeds certain threshold levels. The electricity production credit is reduced over a 3-cent phase-out range to the extent the annual average contract price per kilowatt-hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation).

##### **Open-loop biomass facility**

An open-loop biomass facility is a facility that uses open-loop biomass to produce electricity. For purposes of the credit, open-loop biomass is defined as (1) any agricultural livestock waste nutrients or (2) any solid, nonhazardous, cellulosic waste material or any lignin material that is segregated from other waste materials and which is derived from:

- forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;
- solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, and landscape or right-of-way tree trimmings; or
- agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure. Wood waste materials do not qualify as open-loop biomass to the extent they are pressure treated, chemically treated, or painted. In addition, municipal solid waste, gas derived from the biodegradation of solid waste, and paper that is commonly recycled do not qualify as open-loop biomass. Open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start-up and flame stabilization.

In the case of an open-loop biomass facility that uses agricultural livestock waste nutrients, a qualified facility is one that was originally placed in service after October 22, 2004, and before January 1, 2014, and has a nameplate capacity rating which is not less than 150 kilowatts. In the case of any other open-loop biomass facility, a qualified facility is one that was originally placed in service before January 1, 2014. A qualified facility includes a new power generation unit placed in service after October 3, 2008, at an existing open-loop biomass facility, but only to the extent of the increased amount of electricity produced at the existing facility by reason of such new unit.

#### **Explanation of Provision**

The provision extends for one year, through December 31, 2010, the credit available to qualified open-loop biomass facilities (other than facilities described in section 45(d)(3)(A)(i) that use agricultural livestock waste nutrients) placed in service before October 22, 2004. The credit for electricity produced during this extended period (January 1, 2010, through December 31, 2010) is limited to 80 percent of the credit that would otherwise be available with respect to such facilities.

#### **Effective Date**

The provision is effective for electricity produced and sold after December 31, 2009.

#### **4. Extension and modification of credit for steel industry fuel (sec. 204 of the bill and sec. 45 of the Code)**

##### **Present Law**

Each barrel-of-oil equivalent (defined as 5.8 million British thermal units) of steel industry fuel produced at a qualified facility during the credit period receives a \$2 credit. The credit rate is adjusted annually for inflation and for 2010 equals \$2.87 per barrel-of-oil equivalent. Steel industry fuel is defined as a fuel produced through a process of liquefying coal waste sludge, distributing the liquefied product on coal, and using the resulting mixture as a feedstock for the manufacture of coke. Coal waste sludge includes tar decanter sludge and related byproducts of the coking process.

A qualified facility is any facility capable of producing steel industry fuel (or any modification to a facility making it so capable) that is placed in service before January 1, 2010. For facilities capable of producing steel industry fuel on or before October 1, 2008, the credit is available for fuel produced and sold on or after such date and before January 1, 2010. For facilities placed in service or modified to produce steel industry fuel after October 1, 2008, the

credit period begins on the placed-in-service or modification date and ends one year after such date or December 31, 2009, whichever is later.

### **Explanation of Provision**

The provision extends for one year (through December 31, 2010) the placed-in-service period for new steel industry fuel facilities. The provision also changes the credit period to the two-year period beginning on the date that the facility first produces steel industry fuel that is sold to an unrelated person after September 30, 2008.

The provision modifies the definition of steel industry fuel to include fuel produced through a process of distributing liquefied coal waste sludge on a blend of coal and petroleum coke, or on other coke feedstock.

The provision also clarifies that the owner of a facility producing steel industry fuel will be treated as producing and selling steel industry fuel where that owner manufactures such fuel from a feedstock to which it has title. With respect to such a facility, no person (including a ground lessor, customer, supplier, or technology licensor) will be treated as having an ownership interest in the facility or as otherwise entitled to the credit for the production of steel industry fuel if such person's rent, license fee, or other entitlement to net payments from the owner of such facility is measured by a fixed dollar amount or a fixed amount per ton, or is otherwise determined without regard to the profit or loss of such facility. The sale of such steel industry fuel by the owner of the facility to a person who is not the owner of the facility does not fail to qualify as a sale to an unrelated person solely because the purchaser may also be a ground lessor, supplier, or customer.

### **Effective Date**

The extension of the placed-in-service period and the modification of the credit period are effective on the date of enactment. The other modifications are effective as if included in the amendments made by the Energy Improvement and Extension Act of 2008.<sup>57</sup>

## **5. Credit for producing fuel from coke or coke gas (sec. 205 of the bill and sec. 45K)**

### **Present Law**

Coke and coke gas produced in the United States at qualified facilities and sold to unrelated parties are eligible for an income tax credit equal to \$3 (adjusted for inflation and equal to \$3.40 for 2009) per Btu barrel-of-oil equivalent (the "coke credit"). The credit is available for coke or coke gas produced during a four-year period beginning on the later of January 1, 2006, or the date the qualified facility was placed in service. For purposes of the coke credit, qualified facilities are facilities placed in service before January 1, 1993, or after June 30, 1998, and before January 1, 2010. Qualified facilities do not include facilities that produce petroleum-based coke or coke gas. No credit is allowed with respect to coke produced from steel industry fuel if a

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<sup>57</sup> Pub. L. No. 110-343.

credit is allowed for such fuel under section 45. The amount of credit-eligible coke produced at any one facility may not exceed an average barrel-of-oil equivalent of 4,000 barrels per day. The coke credit is part of the general business credit.

### **Explanation of Provision**

The provision extends for one year the placed in service date for qualified facilities.

### **Effective Date**

The provision is effective for facilities placed in service after December 31, 2009.

## **6. New energy efficient home credit (sec. 206 of the bill and sec. 45L of the Code)**

### **Present Law**

The Code provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on August 8, 2005, and any applicable Federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals \$1,000 in the case of a new home that meets the 30-percent standard and \$2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the \$1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2003 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the \$1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes that are purchased prior to January 1, 2010. The credit is part of the general business credit.



### **Explanation of Provision**

The provision extends the credit to homes that are purchased prior to January 1, 2011.

### **Effective Date**

The provision applies to homes acquired after December 31, 2009.

## **7. Excise tax credits and outlay payments for alternative fuel and alternative fuel mixtures (sec. 207 of the bill and secs. 6426 and 6427(e) of the Code)**

### **Present Law**

The Code provides two per-gallon excise tax credits with respect to alternative fuel: the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term “alternative fuel” means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process (“coal-to-liquids”), compressed or liquified gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after September 30, 2009 through December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 50 percent of such facility’s total carbon dioxide emissions. The sequestration percentage increases to 75 percent for fuel produced after December 30, 2009.

The alternative fuel credit is allowed against section 4041 liability, and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents<sup>58</sup> of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An “alternative fuel mixture” is a mixture of alternative fuel and taxable fuel that contains at least 1/10 of one percent taxable fuel. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits generally expired after December 31, 2009 (September 30, 2014 for liquefied hydrogen).

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expired after

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<sup>58</sup> “Gasoline gallon equivalent” means, with respect to any nonliquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

December 31, 2009. With respect to liquefied hydrogen, the payment provisions expire after September 30, 2014. The alternative fuel credit and alternative fuel mixture credit must first be applied to excise tax liability for special and alternative fuels, and any excess credit may be taken as a payment.

### **Explanation of Provision**

The provision extends the alternative fuel credit, alternative fuel mixture credit, and related payment provisions, for one additional year (through December 31, 2010) for liquefied petroleum gas, compressed or liquefied natural gas, compressed or liquefied gas derived from biomass, and liquid fuel derived from biomass. For purposes of the alternative fuel credit, alternative fuel mixture credit and related payment provisions, the provision excludes fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp.

### **Effective Date**

The provision is effective for fuel sold or used after December 31, 2009.

## **8. Special rule to implement FERC and State electric restructuring policy (sec. 208 of the bill and sec. 451(i) of the Code)**

### **Present Law**

A taxpayer selling property generally recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period<sup>59</sup> (the "reinvestment property").<sup>60</sup> If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by a qualified electric utility to an independent transmission company prior to January 1, 2010. A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both (1) a

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<sup>59</sup> The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

<sup>60</sup> Sec. 451(i).

transmitting utility (as defined in the Federal Power Act)<sup>61</sup> with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act).<sup>62</sup>

In general, an independent transmission company is defined as: (1) an independent transmission provider<sup>63</sup> approved by the Federal Energy Regulatory Commission (“FERC”); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a “market participant” and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider no later than four years after the close of the taxable year in which the transaction occurs; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1). Exempt utility property does not include any property that is located outside of the United States.

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

### **Explanation of Provision**

The provision extends the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility prior to January 1, 2011.

Under the provision, the definition of independent transmission company includes a person who FERC determines—(1) is not itself a market participant as determined by FERC<sup>64</sup> and

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<sup>61</sup> Sec. 3(23), 16 U.S.C. 796, defines “transmitting utility” as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or Federal power marketing agency which owns or operates electric power transmission facilities which are used for the sale of electric energy at wholesale.

<sup>62</sup> Sec. 3(22), 16 U.S.C. 796, defines “electric utility” as any person or State agency (including any municipality) which sells electric energy; such term includes the Tennessee Valley Authority, but does not include any Federal power marketing agency.

<sup>63</sup> For example, a regional transmission organization, an independent system operator, or an independent transmission company.

<sup>64</sup> The provision is not intended to change FERC’s determination of whether a person is a market participant.

also is not controlled<sup>65</sup> by such market participant,<sup>66</sup> or (2) is independent from market participants or is an independent transmission company within the meaning of FERC's rules applicable to independent transmission providers.

### **Effective Date**

The extension provision applies to transactions after December 31, 2009. The modified definition of independent transmission company applies to transactions after date of enactment.

## **9. Suspension of limitation on percentage depletion for oil and gas from marginal wells (sec. 209 of the bill and sec. 613A of the Code)**

### **Present Law**

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.<sup>67</sup> 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.

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.<sup>68</sup> Generally, under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year.<sup>69</sup> The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").<sup>70</sup> The 100-percent net-income limitation for marginal production has been suspended for taxable years beginning before January 1, 2010.

Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily

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<sup>65</sup> For purposes of the provision, a person is treated as controlled by another person if such persons would be treated as a single employer under section 52.

<sup>66</sup> This provision is not intended to alter FERC's definition of control with respect to determining if a person is a market participant.

<sup>67</sup> Secs. 611-613.

<sup>68</sup> Sec. 613A.

<sup>69</sup> Sec. 613A(c).

<sup>70</sup> Sec. 613(a).

production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).<sup>71</sup>

### **Explanation of Provision**

The provision extends the suspension of the 100-percent net-income limitation for marginal production for one year (to apply to tax years beginning before January 1, 2011).

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2009.

## **10. Direct payment for energy efficient appliances (sec. 210 of the bill and sec. 45M of the Code)**

### **Present Law**

#### **In general**

A credit is allowed for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators. The credit is part of the general business credit.

The credits are as follows:

#### **Dishwashers**

\$45 in the case of a dishwasher that is manufactured in calendar year 2008 or 2009 that uses no more than 324 kilowatt hours per year and 5.8 gallons per cycle, and

\$75 in the case of a dishwasher that is manufactured in calendar year 2008, 2009, or 2010 and that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

#### **Clothes washers**

\$75 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 that meets or exceeds a 1.72 modified energy factor and does not exceed a 8.0 water consumption factor, and

\$125 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 or 2009 that meets or exceeds a 1.8 modified energy factor and does not exceed a 7.5 water consumption factor,

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<sup>71</sup> The American Petroleum Institute gravity, or API gravity, is a measure of how heavy or light a petroleum liquid is compared to water.

\$150 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009 or 2010 that meets or exceeds a 2.0 modified energy factor and does not exceed a 6.0 water consumption factor, and

\$250 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor.

### Refrigerators

\$50 in the case of a refrigerator manufactured in calendar year 2008 that consumes at least 20 percent but not more than 22.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

\$75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but no more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

\$100 in the case of a refrigerator that is manufactured in calendar year 2008, 2009 or 2010 that consumes at least 25 percent but not more than 29.9 percent less kilowatt hours per year than the 2001 energy conservation standards, and

\$200 in the case of a refrigerator manufactured in calendar year 2008, 2009 or 2010 that consumes at least 30 percent less energy than the 2001 energy conservation standards.

### Definitions

A dishwasher is any residential dishwasher subject to the energy conservation standards established by the Department of Energy. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

The term “modified energy factor” means the modified energy factor established by the Department of Energy for compliance with the Federal energy conservation standard.

The term “gallons per cycle” means, with respect to a dishwasher, the amount of water, expressed in gallons, required to complete a normal cycle of a dishwasher.

The term “water consumption factor” means, with respect to a clothes washer, the quotient of the total weighted per-cycle water consumption divided by the cubic foot (or liter) capacity of the clothes washer.

### Other rules

Appliances eligible for the credit include only those produced in the United States and that exceed the average amount of U.S. production from the two prior calendar years for each category of appliance. The aggregate credit amount allowed with respect to a taxpayer for all

taxable years beginning after December 31, 2007 may not exceed \$75 million, with the exception that the \$200 refrigerator credit and the \$250 clothes washer credit are not limited. Additionally, the credit allowed in a taxable year for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

### **Explanation of Provision**

The provision provides that a taxpayer may elect to receive a direct payment, in lieu of the present law tax credit, equal to 85 percent of the amount of the credit otherwise determined. The taxpayer may make elections separately with respect to 2009 and 2010, and once the election is made it is irrevocable. The payment is not included in gross income or alternative minimum taxable income.

### **Effective Date**

The provision is effective with respect to taxable years that include the last day of calendar year 2009 or the last day of calendar year 2010.

## **11. Credit for nonbusiness energy property (sec. 211 of the bill and sec. 25C of the Code)**

### **Present Law**

#### **In general**

Section 25C provides a 30-percent credit for the purchase of qualified energy efficiency improvements to the envelope of existing homes. Additionally, section 25C provides a 30 percent credit for the purchase of (1) qualified natural gas, propane, or oil furnace or hot water boilers, (2) qualified energy efficient property, and (3) advanced main air circulating fans.

The credit applies to expenditures made after December 31, 2008 for property placed in service after December 31, 2008, and prior to January 1, 2011.<sup>72</sup> The aggregate amount of the credit allowed for a taxpayer for taxable years beginning in 2009 and 2010 is \$1,500.

#### **Building envelope improvements**

A qualified energy efficiency improvement is any energy efficiency building envelope component (1) that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code<sup>73</sup> as supplemented and as in effect on

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<sup>72</sup> With the exception of biomass fuel property, property placed in service after December 31, 2008 and prior to February 17, 2009 qualifies for the new 30 percent credit rate (and \$1,500 aggregate cap) if it met the efficiency standards of prior law for property placed in service during 2009. Biomass fuel property placed in service at any point in 2009 is governed by the new efficiency standard.

<sup>73</sup> This reference to the 2000 International Energy Conservation Code is superseded by the additional requirements described in the paragraph below regarding building envelope components.

August 8, 2005 (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling and which meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009); (2) exterior windows (including skylights) and doors provided such component has a U-factor and a seasonal heat gain coefficient ("SHGC") of 0.3 or less; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

### **Other eligible property**

#### **Qualified natural gas, propane, or oil furnace or hot water boilers**

A qualified natural gas, propane, or oil hot water boiler is a natural gas, propane, or oil hot water boiler with an annual fuel utilization efficiency rate of at least 90. A qualified natural gas or propane furnace is a natural gas or propane furnace with an annual fuel utilization efficiency rate of at least 95. A qualified oil furnace is an oil furnace with an annual fuel utilization efficiency rate of at least 90.

#### **Qualified energy-efficient property**

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which achieves the highest efficiency tier of Consortium for Energy Efficiency, as in effect on January 1, 2009,<sup>74</sup> (3) a central air conditioner with energy efficiency of at least the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2009,<sup>75</sup> (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent as measured using a

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<sup>74</sup> These standards are a seasonal energy efficiency ratio ("SEER") greater than or equal to 15, an energy efficiency ratio ("EER") greater than or equal to 12.5, and heating seasonal performance factor ("HSPF") greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

<sup>75</sup> These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.



lower heating value. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants, grasses, residues, and fibers).

#### Advanced main air circulating fan

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace originally placed in service by the taxpayer during the taxable year, and which has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

#### Additional rules

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

#### Explanation of Provision

The provision modifies the standards for exterior windows (including skylights) and doors (other than garage doors) to provide that any such component placed in service after 90 days after the date of enactment of this Act must meet the criteria for such component established by the 2010 Energy Star Program Requirements for Residential Windows, Doors, and Skylights, Version 5.0 (or any subsequent version of such requirements which is in effect after January 4, 2010) in order to be eligible for the credit. For exterior windows (including skylights) and doors (other than garage doors) placed in service after the date of enactment of this Act but before 90 days after the date of enactment of this Act, such component must meet the aforementioned Energy Star criteria for such component to be eligible for the credit, or meet the present law criteria of a U factor of 0.30 or less and a SHGC of 0.30 or less. The energy efficiency requirements for garage doors are unchanged by the Act. Such components must continue to meet the present law criteria of a U factor of 0.30 or less and a SHGC of 0.30 or less to be eligible.

#### Effective Date

The provision applies to property placed in service after the date of enactment.

## **B. Individual Tax Relief**

### **1. Deduction for certain expenses of elementary and secondary school teachers (sec. 221 of the bill and sec. 62(a)(2)(D) of the Code)**

#### **Present Law**

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. With the exception of taxable years beginning in 2010, an individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of a threshold amount. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2010, an above-the-line deduction is allowed for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.<sup>76</sup> To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade twelve teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2009.

#### **Explanation of Provision**

The provision extends the deduction for eligible educator expenses for one year so that it is available for taxable years beginning before January 1, 2011.

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<sup>76</sup> Sec. 62(a)(2)(D).

### **Effective Date**

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

## **2. Additional standard deduction for State and local real property taxes (sec. 222 of the bill and sec. 63 of the Code)**

### **Present Law**

#### **In general**

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions. Unless an individual taxpayer elects, no itemized deduction is allowed for the taxable year. The deduction for certain taxes, including income taxes, real property taxes, and personal property taxes, generally is an itemized deduction.<sup>77</sup>

#### **Special rule for State and local property taxes**

An individual taxpayer's standard deduction for a taxable year beginning in 2009 is increased by the lesser of (1) the amount allowable<sup>78</sup> to the taxpayer as a deduction for State and local taxes described in section 164(a)(1) (relating to real property taxes), or (2) \$500 (\$1,000 in the case of a married individual filing jointly). The increased standard deduction is determined by taking into account real estate taxes for which a deduction is allowable to the taxpayer under section 164 and, in the case of a tenant-stockholder in a cooperative housing corporation, real estate taxes for which a deduction is allowable to the taxpayer under section 216. No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction.

### **Explanation of Provision**

The provision extends the additional standard deduction for State and local property taxes for one year so that it is available for taxable years beginning before January 1, 2011.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2009.

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<sup>77</sup> If the deduction for State and local taxes is attributable to business or rental income, the deduction is allowed in computing adjusted gross income and therefore is not an itemized deduction.

<sup>78</sup> In the case of an individual taxpayer who does not elect to itemize deductions, although no itemized deductions are allowed to the taxpayer, itemized deductions are nevertheless treated as "allowable." See section 63(e).

### **3. Deduction for State and local general sales taxes (sec. 223 of the bill and sec. 164 of the Code)**

#### **Present Law**

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004-2009, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

The term "general sales tax" means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

#### **Explanation of Provision**

The provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes is extended for one year (through December 31, 2010).

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2009.

#### **4. Contributions of capital gain real property made for conservation purposes (sec. 224 of the bill and sec. 170 of the Code)**

### **Present Law**

#### **Charitable contributions generally**

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.<sup>79</sup>

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, (i.e., taxpayer's adjusted gross income computed without regard to any net operating loss carryback). The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions by an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

#### **Capital gain property**

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section

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<sup>79</sup> Secs. 170, 2055, and 2522, respectively.

170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

### **Qualified conservation contributions**

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property.<sup>80</sup> A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules as other charitable contributions of capital gain property.

### **Special rule regarding contributions of capital gain real property for conservation purposes**

#### **In general**

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005,<sup>81</sup> the 30-percent contribution base limitation on

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<sup>80</sup> Secs. 170(f)(3)(B)(iii) and 170(h).

<sup>81</sup> Sec. 170(b)(1)(E).

contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of \$100 makes a qualified conservation contribution of property with a fair market value of \$80 and makes other charitable contributions subject to the 50-percent limitation of \$60. The individual is allowed a deduction of \$50 in the current taxable year for the non-conservation contributions (50 percent of the \$100 contribution base) and is allowed to carry over the excess \$10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire \$80 qualified conservation contribution may be carried forward for up to 15 years.

#### Farmers and ranchers

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the \$50 deduction for non-conservation contributions, an additional \$50 for the qualified conservation contribution is allowed and \$30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.<sup>82</sup>

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made on or before August 17, 2006.

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<sup>82</sup> Sec. 170(b)(2)(B).

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

### Termination

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2009.<sup>83</sup>

### Explanation of Provision

The Act extends the special rule regarding contributions of capital gain real property for conservation purposes for one year for contributions made in taxable years beginning before January 1, 2011.

### Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

## **5. Above-the-line deduction for qualified tuition and related expenses (sec. 225 of the bill and sec. 222 of the Code)**

### Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.<sup>84</sup> The term qualified tuition and related expenses is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.<sup>85</sup> The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

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<sup>83</sup> Secs. 170(b)(1)(E)(vi) and 170(b)(2)(B)(iii).

<sup>84</sup> Sec. 222.

<sup>85</sup> The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.



The maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2009.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,<sup>86</sup> and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.<sup>87</sup> Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

### **Explanation of Provision**

The provision extends the qualified tuition deduction for one year so that it is generally available for taxable years beginning before January 1, 2011.

The provision also modifies the deduction so that it is unavailable to a taxpayer for whom a credit for higher education under section 25A (the Hope and Lifetime Learning credits) would have provided a greater net reduction in tax liability, without regard to any disallowance or reduction in value of the credit as a result of the alternative minimum tax.

### **Effective Date**

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

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<sup>86</sup> Secs. 222(d)(1) and 25A(g)(2).

<sup>87</sup> Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

## **6. Tax-free distributions from individual retirement plans for charitable purposes (sec. 226 of the bill and sec. 408 of the Code)**

### **Present Law**

#### **In general**

If an amount withdrawn from a traditional individual retirement arrangement (“IRA”) or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

#### **Charitable contributions**

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to the following entities: (1) a charity described in section 501(c)(3); (2) certain veterans’ organizations, fraternal societies, and cemetery companies;<sup>88</sup> and (3) a Federal, State, or local governmental entity, but only if the contribution is made for exclusively public purposes.<sup>89</sup> The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>90</sup>

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.<sup>91</sup>

A payment to a charity (regardless of whether it is termed a “contribution”) in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any

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<sup>88</sup> Secs. 170(c)(3)-(5).

<sup>89</sup> Sec. 170(c)(1).

<sup>90</sup> Secs. 170(b) and (e).

<sup>91</sup> Sec. 170(a).

such good or service provided) to the taxpayer in consideration for the contribution.<sup>92</sup> In addition, present law requires that any charity that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.<sup>93</sup>

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer’s contribution base, which is the taxpayer’s adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer’s contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer’s contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer’s contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.<sup>94</sup> Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.<sup>95</sup> For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

## **IRA rules**

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except

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<sup>92</sup> Sec. 170(f)(8). For any contribution of a cash, check, or other monetary gift, no deduction is allowed unless the donor maintains as a record of such contribution a bank record or written communication from the donee charity showing the name of the donee organization, the date of the contribution, and the amount of the contribution. Sec. 170(f)(17).

<sup>93</sup> Sec. 6115.

<sup>94</sup> Secs. 170(f), 2055(e)(2), and 2522(c)(2).

<sup>95</sup> Sec. 170(f)(2).

to the extent the withdrawal represents a return of nondeductible contributions). Certain individuals also may make nondeductible contributions to a Roth IRA (deductible contributions cannot be made to Roth IRAs). Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by April 1 of the calendar year following the year in which the IRA owner attains age 70½.<sup>96</sup>

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;<sup>97</sup> (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.<sup>98</sup> Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

### **Qualified charitable distributions**

Present law provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.<sup>99</sup>

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<sup>96</sup> Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

<sup>97</sup> Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

<sup>98</sup> Sec. 3405.

<sup>99</sup> Sec. 408(d)(8). The exclusion does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions (“SEPs”).

The exclusion may not exceed \$100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. A qualified charitable distribution is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½ and only to the extent the distribution would be includible in gross income (without regard to this provision).

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the qualified charitable distribution provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under section 170.

The exclusion for qualified charitable distributions applies to distributions made in taxable years beginning after December 31, 2005. Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2009.

### **Explanation of Provision**

The provision extends the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2009, and before January 1, 2011.

### **Effective Date**

The provision is effective for distributions made in taxable years beginning after December 31, 2009.

### **7. Special rule for regulated investment company stock held in the estate of a nonresident non-citizen (sec. 227 of the bill and sec. 2105 of the Code)**

#### **Present Law**

The gross estate of a decedent who was a U.S. citizen or resident generally includes all property – real, personal, tangible, and intangible – wherever situated.<sup>100</sup> The gross estate of a nonresident non-citizen decedent, by contrast, generally includes only property that at the time of the decedent's death is situated within the United States.<sup>101</sup> Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments, but does not include either bank deposits or portfolio obligations the interest on which would be exempt from U.S. income tax under section 871.<sup>102</sup> Stock owned and held by a nonresident non-citizen generally is treated as property within the United States if the stock was issued by a domestic corporation.<sup>103</sup>

Treaties may reduce U.S. taxation of transfers of the estates of nonresident non-citizens. Under recent treaties, for example, U.S. tax generally may be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Although stock issued by a domestic corporation generally is treated as property within the United States, stock of a regulated investment company ("RIC") that was owned by a nonresident non-citizen is not deemed property within the United States in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (the "estate tax look-through rule for RIC stock").<sup>104</sup> This estate tax look-through rule for RIC stock does not apply to estates of decedents dying after December 31, 2009.

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<sup>100</sup> Sec. 2031. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA's rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

<sup>101</sup> Sec. 2103.

<sup>102</sup> Secs. 2104(c), 2105(b).

<sup>103</sup> Sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

<sup>104</sup> Sec. 2105(d).

### **Explanation of Provision**

The provision permits the estate tax look-through rule for RIC stock to apply to estates of decedents dying before January 1, 2011.<sup>105</sup>

### **Effective Date**

The provision is effective for decedents dying after December 31, 2009.

## **8. Election for direct payment of low-income housing credit for 2010 (sec. 231 of the bill and sec. 42 of the Code)**

### **Present Law**

#### **Tax credits**

##### **In general**

The low-income housing credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels.<sup>106</sup> 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. Generally, the applicable percentage is 70 percent for a new non-Federally subsidized building and 30 percent for all other buildings. Generally, a new building is considered Federally-subsidized if it also receives tax-exempt bond financing. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

##### **Volume limits**

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

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<sup>105</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA’s rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

<sup>106</sup> Sec. 42.

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.<sup>107</sup> These amounts are indexed for inflation.

Certain buildings that also receive financing with proceeds of tax-exempt bonds do not require an allocation of the low-income housing credit. Generally, these buildings are buildings where 50 percent or more of the aggregate basis of the building and the land on which the building is located is financed with obligations tax-exempt under section 103 and subject to the private activity bond volume limits.<sup>108</sup>

#### Basic rule for Federal grants

The eligible basis of a qualified building must be reduced by the amount of any Federal grants with respect to such building.

#### **Grants in lieu of tax credits for 2009**

##### Low-income housing grant election amount

Under a special rule, the Secretary of the Treasury is authorized to provide a grant to each State's housing credit agency in an amount equal to the low-income housing grant election amount for 2009.

The low-income housing grant election amount for a State is an amount elected by the State subject to certain limits. The maximum low-income housing grant election amount for a State may not exceed 85 percent of the product of ten (i.e., the length of the credit period) and the sum of the State's: (1) unused housing credit ceiling for 2008; (2) any returns to the State during 2009 of credit allocations previously made by the State; (3) 40 percent of the State's 2009 credit allocation (either a per capital amount or the small State minimum annual cap); and (4) 40 percent of the State's share of the national pool allocated in 2009, if any.

These grants are not taxable income to recipients.

##### Subawards to low-income housing credit buildings

A State receiving a grant under this election is to use these monies to make subawards to finance the construction or acquisition and rehabilitation of qualified low-income buildings as defined under the low-income housing credit. A subaward may be made to finance a qualified low-income building regardless of whether the building has an allocation of low-income housing credit. However, in the case of qualified low-income buildings without allocations of the low-income housing credit, the State housing credit agency must make a determination that the subaward with respect to such building will increase the total funds available to the State to build and rehabilitate affordable housing. In conjunction with this determination the State housing

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<sup>107</sup> Rev. Proc. 2009-50.

<sup>108</sup> sec. 146



credit agency must establish a process in which applicants for the subawards must demonstrate good faith efforts to obtain investment commitments before the agency makes such subawards.

Any building receiving a subaward must satisfy the low-income housing credit rules. The State housing credit agency shall perform asset management functions to ensure compliance with the low-income housing credit rules and the long-term viability of buildings financed with these subawards.<sup>109</sup> Failure to satisfy the low-income housing credit rules will result in recapture enforced by means of liens or other methods that the Secretary (or delegate) deems appropriate. Any such recapture will be payable to the Secretary for deposit in the general fund of the Treasury.

Any grant funds not used to make subawards before January 1, 2011, and any subawards returned on or after January 1, 2011, must be returned to the Secretary.

#### Basic rule for Federal grants

Subawards received under the grant election do not reduce the eligible basis of a qualified low-income building.

#### Reduction in low-income housing credit volume limit for 2009

The otherwise applicable component or components of the aggregate housing credit dollar amount for any State for 2009 are reduced by the amount taken into account in determining the low-income housing grant election amount.

#### Appropriations

Present law appropriates to the Secretary such sums as may be necessary to carry out this provision.

### **Explanation of Provision**

#### **Direct payment**

The provision creates a refundable tax credit for 2010 (rather than extends to 2010 the 2009 election to substitute grants for nonrefundable tax credits). Specifically, the provision allows each State a refundable low-income housing tax credit to finance low-income buildings through subawards to taxpayers. The amount of such refundable credit for each State shall equal the low-income housing refundable tax credit election amount. Each State's otherwise applicable State housing credit ceiling is reduced by the amount of the State's low-income housing refundable tax credit election amount.

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<sup>109</sup> The State housing credit agency may collect reasonable fees from subaward recipients to cover the expenses of the agency's asset management duties. Alternatively, the State housing credit agency may retain a third party to perform these asset management duties.

For 2010, the maximum low-income housing refundable credit election amount for a State may not exceed 85 percent of the product of ten and the sum of the State's: (1) unused housing credit ceiling for 2009; (2) any returns to the State during 2010 of credit allocations previously made by the State; (3) 40 percent of the State's 2010 credit allocation (either a per capital amount or the small State minimum annual cap); and (4) 40 percent of the State's share of the national pool allocated in 2010, if any.

Any refundable tax credits allowed under this provision not used to make subawards before January 1, 2012 and any subawards to taxpayers under this provision returned on or after January 1, 2012 must be returned to the Secretary.

The subawards made under the provision do not reduce the eligible basis of a qualified low-income building.

No change is made to the operation of the 2009 election.

#### **Effective Date**

The provision is effective on the date of enactment.

## **C. Business Tax Relief**

### **1. Research credit (sec. 241 of the bill and sec. 41 of the Code)**

#### **Present Law**

##### **General rule**

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.<sup>110</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research.

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.<sup>111</sup>

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, 2009.<sup>112</sup>

##### **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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<sup>110</sup> Sec. 41.

<sup>111</sup> Sec. 41(e).

<sup>112</sup> 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.<sup>113</sup>

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.<sup>114</sup> 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 which 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.<sup>115</sup>

### **Alternative simplified credit**

Taxpayers may elect to claim an alternative simplified credit for qualified research expenses. 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

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<sup>113</sup> 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).

<sup>114</sup> Sec. 41(f)(1).

<sup>115</sup> Sec. 41(f)(3).

taxpayer's behalf (so-called contract research expenses).<sup>116</sup> Notwithstanding the limitation for 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.<sup>117</sup> In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.<sup>118</sup> 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.<sup>119</sup> 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.<sup>120</sup> Taxpayers

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<sup>116</sup> 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 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).

<sup>117</sup> Sec. 41(d)(3).

<sup>118</sup> Sec. 41(d)(4).

<sup>119</sup> 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).

<sup>120</sup> Sec. 280C(c).

may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.<sup>121</sup>

### **Explanation of Provision**

The provision extends the research credit for one year, through December 31, 2010.

### **Effective Date**

The provision is effective for amounts paid or incurred after December 31, 2009.

## **2. Indian employment tax credit (sec. 242 of the bill and sec. 45A of the Code)**

### **Present Law**

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees.<sup>122</sup> The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974<sup>123</sup> or section 4(1) of the Indian Child Welfare Act of 1978.<sup>124</sup> For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee

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<sup>121</sup> Sec. 280C(c)(3).

<sup>122</sup> Sec. 45A.

<sup>123</sup> Pub. L. No. 93-262.

<sup>124</sup> Pub. L. No. 95-608.

during the taxable year exceeds an amount determined at an annual rate of \$30,000 (which after adjusted for inflation is currently \$45,000 for 2009). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a five percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred in taxable years that begin before January 1, 2010.

### **Explanation of Provision**

The provision extends for one year the present-law employment credit provision (through taxable years beginning on or before December 31, 2010).

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2009.

## **3. New markets tax credit (sec. 243 of the bill and sec. 45D of the Code)**

### **Present Law**

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").<sup>125</sup> 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.<sup>126</sup> 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.<sup>127</sup> 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.<sup>128</sup>

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<sup>125</sup> 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).

<sup>126</sup> Sec. 45D(a)(2).

<sup>127</sup> Sec. 45D(a)(3).

<sup>128</sup> Sec. 45D(g).

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 by 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.<sup>129</sup> 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.<sup>130</sup> 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 loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.<sup>131</sup>

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.<sup>132</sup> 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.<sup>133</sup> 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<sup>134</sup> (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,

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<sup>129</sup> Sec. 45D(c).

<sup>130</sup> Sec. 45D(b).

<sup>131</sup> Sec. 45D(d).

<sup>132</sup> Sec. 45D(e).

<sup>133</sup> Sec. 45D(e)(2).

<sup>134</sup> Pub. L. No. 103-325.



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.<sup>135</sup> 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 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.<sup>136</sup>

The maximum annual amount of qualified equity investments was \$5.0 billion for calendar years 2008 and 2009. The new markets tax credit expired on December 31, 2009.

### **Explanation of Provision**

The provision extends the new markets tax credit for one year, through 2010, permitting up to \$5 billion in qualified equity investments for that calendar year. The provision also extends for one year, through 2015, the carryover period for unused new markets tax credits.

### **Effective Date**

The provision applies to calendar years beginning after 2009.

## **4. Railroad track maintenance credit (sec. 244 of the bill and sec. 45G of the Code)**

### **Present Law**

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during the taxable year.<sup>137</sup> The credit is limited to the product of \$3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.<sup>138</sup> Each mile of railroad track may be taken into account only once, either by

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<sup>135</sup> Pub. L. No. 103-325.

<sup>136</sup> Sec. 45D(d)(2).

<sup>137</sup> Sec. 45G(a).

<sup>138</sup> Sec. 45G(b)(1).

the owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit may also reduce a taxpayer's tax liability below its tentative minimum tax.<sup>139</sup>

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).<sup>140</sup>

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.<sup>141</sup>

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.<sup>142</sup>

The provision applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning before January 1, 2010.

#### **Explanation of Provision**

The provision extends the present law credit for one year, for qualified railroad track maintenance expenditures paid or incurred before January 1, 2011.

#### **Effective Date**

The provision is effective for expenses paid or incurred in taxable years beginning after December 31, 2009.

### **5. Mine rescue team training credit (sec. 245 of the bill and sec. 45N of the Code)**

#### **Present Law**

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) \$10,000. A qualified mine rescue team employee is any full-time

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<sup>139</sup> Sec. 38(c)(4).

<sup>140</sup> Sec. 45G(d).

<sup>141</sup> Sec. 45G(c).

<sup>142</sup> Sec. 45G(e)(1).

employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20 hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction. The credit is not allowable for purposes of computing the alternative minimum tax.<sup>143</sup>

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. The term "wages" has the meaning given to such term by section 3306(b)<sup>144</sup> (determined without regard to any dollar limitation contained in that section).

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.<sup>145</sup> The credit does not apply to taxable years beginning after December 31, 2009.

The credit may not offset the alternative minimum tax.

### **Explanation of Provision**

The provision extends the credit for one year through taxable years beginning on or before December 31, 2010.

The provision permits the mine rescue team training credit to offset the alternative minimum tax.

### **Effective Date**

The provision generally is effective for taxable years beginning after December 31, 2009. The provision relating to the alternative minimum tax applies to credits determined in taxable years beginning after December 31, 2009, and to carrybacks of the credits.

## **6. Employer wage credit for activated military reservists (sec. 246 of the bill and sec. 45P of the Code)**

### **Present Law**

#### **Differential pay**

In general, compensation paid by an employer to an employee is deductible by the employer under section 162(a)(1), unless the expense must be capitalized. In the case of an

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<sup>143</sup> Sec. 38(c).

<sup>144</sup> Section 3306(b) defines wages for purposes of Federal Unemployment Tax.

<sup>145</sup> Sec. 280C(e).

employee who is called to active duty with respect to the armed forces of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service less the amount of pay received by the employee from the military. This payment by the employer is often referred to as “differential pay.”

### **Wage credit for differential pay**

If an employer qualifies as an eligible small business employer, the employer is allowed to take a credit against its income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the employer’s qualified employees for the taxable year.<sup>146</sup>

An eligible small business employer means, with respect to a taxable year, any taxpayer which: (1) employed on average less than 50 employees on business days during the taxable year; and (2) under a written plan of the taxpayer, provides eligible differential wage payments to every qualified employee of the taxpayer. Taxpayers under common control are aggregated for purposes of determining whether a taxpayer is an eligible small business employer. The credit is not available with respect to a taxpayer who has failed to comply with the employment and reemployment rights of members of the uniformed services (as provided under Chapter 43 of Title 38 of the United States Code).

Differential wage payment means any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer. The term eligible differential wage payments means so much of the differential wage payments paid to a qualified employee as does not exceed \$20,000. A qualified employee is an individual who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

No deduction may be taken for that portion of compensation which is equal to the credit. In addition, the amount of any other credit otherwise allowable under Chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes) of the Code with respect to compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to such employee.

The differential wage payment credit is part of the general business credit, and thus this credit is subject to the rules applicable to business credits. For example, an unused credit generally may be carried back to the taxable year that precedes an unused credit year or carried forward to each of the 20 taxable years following the unused credit year. Any credit that is included in the general business credit, however, cannot be carried back to a tax year before the first tax year for which that credit is allowable under the effective date of that credit. Thus, the

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<sup>146</sup> Sec. 45P.

differential wage payment credit, if disallowed under section 38(c), cannot be carried back to tax years ending before June 18, 2008. In addition, unlike many of the other credits that are included in the general business credit, the differential wage payment credit is not a “qualified business credit” under section 196(c). Thus, a taxpayer cannot deduct under section 196(c) any differential wage payment credits that remain unused at the end of the 20-year carryforward period.

Rules similar to the rules in section 52(c), which bars the work opportunity tax credit for tax-exempt organizations other than certain farmer’s cooperatives, apply to the differential wage payment credit. Additionally, rules similar to the rules in section 52(e), which limits the work opportunity tax credit allowable to regulated investment companies, real estate investment trusts, and certain cooperatives, apply to the differential wage payment credit.

The credit is not allowable against a taxpayer’s alternative minimum tax liability. The amount of credit otherwise allowable under the income tax rules for compensation paid to any employee must be reduced by the differential wage payment credit with respect to that employee.

There are special rules for trusts and estates and their beneficiaries.

The credit is available with respect to amounts paid after June 17, 2008<sup>147</sup> and before January 1, 2010.

### **Explanation of Provision**

The provision extends the availability of the credit to amounts paid before January 1, 2011.

### **Effective Date**

The provision applies to payments made after December 31, 2009.

## **7. Certain farming business machinery and equipment treated as 5-year property (sec. 247 of the bill and sec. 168 of the Code)**

### **Present Law**

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”).<sup>148</sup> The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.<sup>149</sup> Asset class

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<sup>147</sup> This date is the date of enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110–245.

<sup>148</sup> Sec. 168.

<sup>149</sup> 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

01.1 includes machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agricultural, animal husbandry, and horticultural services. These assets are assigned a class life of 10 years and a recovery period of seven years.

However, Section 168(e)(3)(C)(vii) provides a statutory 5-year recovery period for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business and placed in service before January 1, 2010, and the original use of which commences with the taxpayer after December 31, 2008. For these purposes, the term “farming business” means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.<sup>150</sup> A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.<sup>151</sup>

### **Explanation of Provision**

The provision extends the 5-year recovery period for one year to apply to property placed in service before January 1, 2011.

### **Effective Date**

The provision is effective for property placed in service after December 31, 2009.

## **8. 15-year straight-line cost recovery for qualified leasehold, restaurant, and retail improvement property and new restaurant buildings (sec. 248 of the bill and sec. 168 of the Code)**

### **Present Law**

#### **In general**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>152</sup> The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the

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<sup>150</sup> Treas. Reg. sec. 1.263A-4(a)(4)(i).

<sup>151</sup> Treas. Reg. sec. 1.263A-4(a)(4)(ii).

<sup>152</sup> Sec. 168.

property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

### **Depreciation of leasehold improvements**

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements and qualified restaurant property.

### **Qualified leasehold improvement property**

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2010. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service after December 31, 2009 will be subject to the general rules described above.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

### **Qualified restaurant property**

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2010. Qualified restaurant property is any section 1250 property that is a building (if the building is placed in service before January 1, 2010) or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.<sup>153</sup>

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<sup>153</sup> Sec. 168(e)(7)(A).

Qualified restaurant property is recovered using the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for bonus depreciation.<sup>154</sup> Restaurant property placed in service after December 31, 2009 will be subject to the general rules described above.

### **Qualified retail property**

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period and for qualified retail improvement property placed in service after December 31, 2008 and before January 1, 2010. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public<sup>155</sup> and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. It is generally intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail property is not eligible for bonus depreciation.<sup>156</sup> Retail property placed in service in 2010 and later will be subject to the general rules described above.

### **Explanation of Provision**

The present law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property are extended for one year to apply to property placed in service on or before December 31, 2010.

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<sup>154</sup> Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

<sup>155</sup> Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

<sup>156</sup> Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.



### **Effective Date**

The provision is effective for property placed in service after December 31, 2009.

## **9. Seven-year cost recovery period for motorsports entertainment complexes (sec. 249 of the bill and sec. 168 of the Code)**

### **Present Law**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>157</sup> The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years. Additionally, a motorsports entertainment complex placed in service before December 31, 2009 is assigned a recovery period of seven years.<sup>158</sup> For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land that during the 36-month period following its placed-in-service date it hosts a racing event.<sup>159</sup> The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands).

### **Explanation of Provision**

The provision extends the availability of the present law seven-year recovery period for motorsports entertainment complexes one year to apply to property placed in service before January 1, 2011.

### **Effective Date**

The provision is effective for property placed in service after December 31, 2009.

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<sup>157</sup> Sec. 168.

<sup>158</sup> Sec. 168(e)(3)(C)(ii).

<sup>159</sup> Sec. 168(i)(15).

## 10. Accelerated depreciation for business property on Indian reservations (sec. 250 of the bill and sec. 168(j) of the Code)

### Present Law

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) are determined using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

“Qualified Indian reservation property” eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;<sup>160</sup> and (4) is not property placed in service for purposes of conducting gaming activities.<sup>161</sup> Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).<sup>162</sup>

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974<sup>163</sup> or section 4(10) of the Indian Child Welfare Act of 1978.<sup>164</sup> For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are (1) within the jurisdictional area of an

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<sup>160</sup> For these purposes, related persons is defined in Sec. 465(b)(3)(C).

<sup>161</sup> Sec. 168(j)(4)(A).

<sup>162</sup> Sec. 168(j)(4)(C).

<sup>163</sup> Pub. L. No. 93-262.

<sup>164</sup> Pub. L. No. 95-608.

Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2010.

### **Explanation of Provision**

The provision extends for one year the present-law incentive relating to depreciation of qualified Indian reservation property to apply to property placed in service through December 31, 2010.

### **Effective Date**

The provision is effective for property placed in service after December 31, 2009.

## **11. Enhanced charitable deduction for contributions of food inventory (sec. 251 of the bill and sec. 170 of the Code)**

### **Present Law**

#### **Charitable contributions in general**

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.<sup>165</sup>

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

#### **General rules regarding contributions of food inventory**

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

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<sup>165</sup> Sec. 170.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.<sup>166</sup> In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.<sup>167</sup> To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.<sup>168</sup> In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.<sup>169</sup>

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.<sup>170</sup> Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.<sup>171</sup>

### **Temporary rule expanding and modifying the enhanced deduction for contributions of food inventory**

Under a special temporary provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory.<sup>172</sup> For taxpayers other than C corporations, the total deduction for donations of food

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<sup>166</sup> Sec. 170(e)(3).

<sup>167</sup> Sec. 170(b)(2).

<sup>168</sup> Sec. 170(e)(3)(A)(i)-(iii).

<sup>169</sup> Sec. 170(e)(3)(A)(iv).

<sup>170</sup> Treas. Reg. sec. 1.170A-4A(c)(3).

<sup>171</sup> *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

<sup>172</sup> Sec. 170(e)(3)(C).

inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.<sup>173</sup>

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." Apparently wholesome food is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The temporary provision does not apply to contributions made after December 31, 2009.

### **Explanation of Provision**

The provision extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2011.

### **Effective Date**

The provision is effective for contributions made after December 31, 2009.

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<sup>173</sup> The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

## **12. Enhanced charitable deduction for contributions of book inventories to public schools (sec. 252 of the bill and sec. 170 of the Code)**

### **Present Law**

#### **Charitable contributions in general**

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.<sup>174</sup>

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

#### **General rules regarding contributions of book inventory**

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or, if less, the fair market value of the inventory.

In general, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.<sup>175</sup> In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.<sup>176</sup> To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.<sup>177</sup> In the case of contributed property subject to the Federal

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<sup>174</sup> Sec. 170.

<sup>175</sup> Sec. 170(e)(3).

<sup>176</sup> Sec. 170(b)(2).

<sup>177</sup> Sec. 170(e)(3)(A)(i)-(iii).

Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.<sup>178</sup>

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.<sup>179</sup> Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

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

### **Special rule expanding and modifying the enhanced deduction for contributions of book inventory**

The generally applicable enhanced deduction for C corporations is expanded and modified to include certain qualified book contributions made after August 28, 2005, and before January 1, 2010.<sup>180</sup> A qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that 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. The enhanced deduction for qualified book contributions is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs. The donee also must make the certifications required for the generally applicable enhanced deduction, i.e., the donee will (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

### **Explanation of Provision**

The provision extends the expansion of, and modifications to, the enhanced deduction for contributions of book inventory to contributions made before January 1, 2011.

### **Effective Date**

The provision is effective for contributions made after December 31, 2009.

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<sup>178</sup> Sec. 170(e)(3)(A)(iv).

<sup>179</sup> Treas. Reg. sec. 1.170A-4A(c)(3).

<sup>180</sup> Sec. 170(e)(3)(D).

### **13. Enhanced charitable deduction for corporate contributions of computer technology and equipment for educational purposes (sec. 253 of the bill and sec. 170 of the Code)**

#### **Present Law**

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.<sup>181</sup>

A taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified computer contribution."<sup>182</sup> This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2009.<sup>183</sup>

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed or assembled the property, not later than the date construction or assembly of the property is substantially completed.<sup>184</sup> The original use of the property must be by the donor or the donee,<sup>185</sup> and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed or assembled by the taxpayer, the rules

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<sup>181</sup> Sec. 170(e)(1).

<sup>182</sup> Secs. 170(e)(4) and 170(e)(6).

<sup>183</sup> Sec. 170(e)(6)(G).

<sup>184</sup> If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

<sup>185</sup> This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).



applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.<sup>186</sup>

### **Explanation of Provision**

The provision extends the enhanced deduction for computer technology and equipment to contributions made during taxable years beginning after December 31, 2009, and before January 1, 2011.

### **Effective Date**

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

## **14. Election to expense mine safety equipment (sec. 254 of the bill and sec. 179E of the Code)**

### **Present Law**

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”).<sup>187</sup> Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or “expense”) such costs under section 179. Present law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2009 and 2010 is \$250,000 of the cost of the qualifying property for the taxable year. 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. The \$250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000.

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.<sup>188</sup> The deduction under section 179E is allowed for both regular and alternative

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<sup>186</sup> Sec. 170(e)(6)(C).

<sup>187</sup> Sec. 168.

<sup>188</sup> Sec. 179E(a).

minimum tax purposes, including adjusted current earnings. In computing earnings and profits, the amount deductible under section 179E is allowed as a deduction ratably over five taxable years beginning with the year the amount is deductible under section 179E.<sup>189</sup>

“Qualified advanced mine safety equipment property” means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service before January 1, 2010.<sup>190</sup>

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.<sup>191</sup>

The portion of the cost of any property with respect to which an expensing election under section 179 is made may not be taken into account for purposes of the 50-percent deduction under section 179E.<sup>192</sup> In addition, a taxpayer making an election under section 179E must file with the Secretary a report containing information with respect to the operation of the mines of the taxpayer as required by the Secretary.<sup>193</sup>

### **Explanation of Provision**

The provision extends for one year, to December 31, 2010, the placed in service termination date for the present-law rule relating to expensing of mine safety equipment.

### **Effective Date**

The provision applies to property placed in service after December 31, 2009.

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<sup>189</sup> Sec. 312(k)(3). Section 56(g)(4)(C)(i) does not apply to a deduction under section 179E (or under sections 179, 179A, 179B, and 179D), as such deduction is permitted for purposes of computing earnings and profits.

<sup>190</sup> Secs. 179E(c) and (g).

<sup>191</sup> Sec. 179E(d).

<sup>192</sup> Sec. 179E(e).

<sup>193</sup> Sec. 179E(f).

## **15. Special expensing rules for certain film and television productions (sec. 255 of the bill and sec. 181 of the Code)**

### **Present Law**

The modified accelerated cost recovery system (“MACRS”) does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a “stand-alone” basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Under section 181, taxpayers may elect<sup>194</sup> to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2010, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.<sup>195</sup> Taxpayers may elect to deduct up to \$15 million of the aggregate cost of the film or television production under this section.<sup>196</sup> The threshold is increased to \$20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.<sup>197</sup>

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.<sup>198</sup> The term “compensation” does not include participations and residuals

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<sup>194</sup> See Treas. Reg. section 1.181-2T for rules on making an election under this section.

<sup>195</sup> For this purpose, a production is treated as commencing on the first date of principal photography.

<sup>196</sup> Sec. 181(a)(2)(A).

<sup>197</sup> Sec. 181(a)(2)(B).

<sup>198</sup> Sec. 181(d)(3)(A).

(as defined in section 167(g)(7)(B)).<sup>199</sup> With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes qualify under the provision.<sup>200</sup> Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.<sup>201</sup>

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.<sup>202</sup>

### **Explanation of Provision**

The provision extends the present law expensing provision for one year, to qualified film and television productions commencing prior to January 1, 2011.

### **Effective Date**

The provision applies to qualified film and television productions commencing after December 31, 2009.

## **16. Expensing of environmental remediation costs (sec. 256 of the bill and sec. 198 of the Code)**

### **Present Law**

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.<sup>203</sup> Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense.<sup>204</sup> Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define “capital expenditures” as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use.<sup>205</sup> Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on all relevant facts and circumstances.

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<sup>199</sup> Sec. 181(d)(3)(B).

<sup>200</sup> Sec. 181(d)(2)(B).

<sup>201</sup> Sec. 181(d)(2)(C).

<sup>202</sup> Sec. 1245(a)(2)(C).

<sup>203</sup> Sec. 162.

<sup>204</sup> Treas. Reg. sec. 1.162-4.

<sup>205</sup> Treas. Reg. sec. 1.263(a)-1(b).

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2010, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.<sup>206</sup> The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*<sup>207</sup> and section 263A are treated as qualified environmental remediation expenditures.

A “qualified contaminated site” (a so-called “brownfield”) generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”)<sup>208</sup> cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3) of the Code.

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under section 198.

### **Explanation of Provision**

The provision extends the present law expensing for one year to include expenditures paid or incurred before January 1, 2011.

### **Effective Date**

The provision is effective for expenditures paid or incurred after December 31, 2009.

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<sup>206</sup> Sec. 198.

<sup>207</sup> 418 U.S. 1 (1974).

<sup>208</sup> Pub. L. No. 96-510 (1980).

## **17. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 257 of the bill and sec. 199 of the Code)**

### **Present Law**

#### **General**

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

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

Domestic 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<sup>209</sup> that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film<sup>210</sup> produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.<sup>211</sup> Wages paid to bona fide residents of Puerto Rico

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<sup>209</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

<sup>210</sup> Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

<sup>211</sup> 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. .

generally are not included in the definition of wages for purposes of computing the wage limitation amount.<sup>212</sup>

### **Rules for Puerto Rico**

When used in the Code in a geographical sense, the term “United States” generally includes only the States and the District of Columbia.<sup>213</sup> A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term “United States” includes the Commonwealth of Puerto Rico, but only if all of the taxpayer’s Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations.<sup>214</sup> In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.<sup>215</sup>

The special rules for Puerto Rico apply only with respect to the first four taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2010.

### **Explanation of Provision**

The provision allows the special domestic production activities rules for Puerto Rico to apply for the first five taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2011.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2009.

## **18. Modification of tax treatment of certain payments to controlling exempt organizations (sec. 258 of the bill and sec. 512 of the Code)**

### **Present Law**

In general, organizations exempt from Federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt

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<sup>212</sup> Section 3401(a)(8)(C) excludes wages paid to United States citizens who are bona fide residents of Puerto Rico from the term wages for purposes of income tax withholding.

<sup>213</sup> Sec. 7701(a)(9).

<sup>214</sup> Sec. 199(d)(8)(A).

<sup>215</sup> Sec. 199(d)(8)(B).

functions.<sup>216</sup> In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.<sup>217</sup>

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. In general, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). However, a special rule provides that, for payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (i.e., at arm's length).<sup>218</sup> In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

The special rule does not apply to payments received or accrued after December 31, 2009.

### **Explanation of Provision**

The provision extends the special rule to payments received or accrued before January 1, 2011. Accordingly, under the provision, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of section 482 (i.e., at arm's length). Any such excess is subject to a 20-percent penalty on the larger of such excess determined without regard to any amendment or

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<sup>216</sup> Sec. 511.

<sup>217</sup> Sec. 512(b).

<sup>218</sup> Sec. 512(b)(13)(E).



supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

### **Effective Date**

The provision is effective for payments received or accrued after December 31, 2009.

## **19. Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income (sec. 259 of the bill and secs. 512 and 514 of the Code)**

### **Present Law**

#### **Taxation of unrelated business income**

In general, an organization that is otherwise 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. Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

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. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include: (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption; (2) obligations to pay certain types of annuities; (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; or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property.

Special rules apply in the case of an exempt organization that owns an interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

#### **Special rules for certain qualifying brownfield properties**

##### **In general**

Section 512(b)(19) provides a special exclusion from unrelated business taxable income for the gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property by an eligible taxpayer. The exclusion from unrelated business taxable

income generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. In addition, present law provides an exception from the debt-financed property rules for such properties.

To qualify for the exclusions from unrelated business income and the debt-financed property rules, the eligible taxpayer is required to: (a) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (b) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (c) transfer the remediated site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for purposes of Federal income tax law.<sup>219</sup>

The special exclusion applies only to gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009.<sup>220</sup>

#### Qualifying brownfield properties

The exclusion from unrelated business taxable income applies only to real property that constitutes a qualifying brownfield property. A qualifying brownfield property means real property that is certified, before the taxpayer incurs any eligible remediation expenditures (other than to obtain a Phase I environmental site assessment), by an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located as a brownfield site within the meaning of section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”) (as in effect on the date of enactment of the provision). The taxpayer’s request for certification must include a sworn statement of the taxpayer and supporting documentation of the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the expansion, redevelopment, or reuse of the property given the property’s reasonably anticipated future land uses or capacity for uses of the property (including a Phase I environmental site assessment and, if applicable, evidence of the property’s presence on a local, State, or Federal list of brownfields or contaminated property) and other environmental assessments prepared or obtained by the taxpayer.

#### Eligible taxpayer

An eligible taxpayer with respect to a qualifying brownfield property is an organization exempt from tax under section 501(a) that acquired such property from an unrelated person and paid or incurred a minimum amount of eligible remediation expenditures with respect to such property. The exempt organization (or the qualifying partnership of which it is a partner) is required to pay or incur eligible remediation expenditures with respect to a qualifying brownfield

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<sup>219</sup> A person is related to another person if (1) such person bears a relationship to such other person that is described in section 267(b) (determined without regard to paragraph (9)), or section 707(b)(1), determined by substituting 25 percent for 50 percent each place it appears therein; or (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

<sup>220</sup> Sec. 512(b)(19)(K).

property in an amount that exceeds the greater of: (a) \$550,000; or (b) 12 percent of the fair market value of the property at the time such property is acquired by the taxpayer, determined as if the property were not contaminated.

An eligible taxpayer does not include an organization that is: (1) potentially liable under section 107 of CERCLA with respect to the property; (2) affiliated with any other person that is potentially liable thereunder through any direct or indirect familial relationship or any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to a qualifying brownfield property is conveyed or financed by a contract of sale of goods or services); or (3) the result of a reorganization of a business entity which was so potentially liable.<sup>221</sup>

#### Qualified sale, exchange, or other disposition

A sale, exchange, or other disposition of a qualifying brownfield property is considered qualified if such property is transferred by the eligible taxpayer to an unrelated person, and within one year of such transfer the taxpayer has received a certification (a “remediation certification”) from the Environmental Protection Agency or an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located that, as a result of the taxpayer’s remediation actions, such property would not be treated as a qualifying brownfield property in the hands of the transferee. A taxpayer’s request for a remediation certification must be made no later than the date of the transfer and must include a sworn statement by the taxpayer certifying that: (1) remedial actions that comply with all applicable or relevant and appropriate requirements (consistent with section 121(d) of CERCLA) have been substantially completed, such that there are no hazardous substances, pollutants or contaminants that complicate the expansion, redevelopment, or reuse of the property given the property’s reasonably anticipated future land uses or capacity for uses of the property; (2) the reasonably anticipated future land uses or capacity for uses of the property are more economically productive or environmentally beneficial than the uses of the property in existence on the date the property was certified as a qualifying brownfield property;<sup>222</sup> (3) a remediation plan has been implemented to bring the property in compliance with all applicable local, State, and Federal environmental laws, regulations, and standards and to ensure that remediation protects human health and the environment; (4) the remediation plan, including any physical improvements required to remediate the property, is either complete or substantially complete, and if substantially

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<sup>221</sup> In general, a person is potentially liable under section 107 of CERCLA if: (1) it is the owner and operator of a vessel or a facility; (2) at the time of disposal of any hazardous substance it owned or operated any facility at which such hazardous substances were disposed of; (3) by contract, agreement, or otherwise it arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances; or (4) it accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance. 42 U.S.C. sec. 9607(a) (2004).

<sup>222</sup> For this purpose, use of the property as a landfill or other hazardous waste facility shall not be considered more economically productive or environmentally beneficial.

complete,<sup>223</sup> sufficient monitoring, funding, institutional controls, and financial assurances have been put in place to ensure the complete remediation of the site in accordance with the remediation plan as soon as is reasonably practicable after the disposition of the property by the taxpayer; and (5) public notice and the opportunity for comment on the request for certification (in the same form and manner as required for public participation required under section 117(a) of CERCLA (as in effect on the date of enactment of the provision)) was completed before the date of such request. Public notice must include, at a minimum, publication in a major local newspaper of general circulation.

#### Eligible remediation expenditures

Eligible remediation expenditures means, with respect to any qualifying brownfield property: (1) expenditures that are paid or incurred by the taxpayer to an unrelated person to obtain a Phase I environmental site assessment of the property; (2) amounts paid or incurred by the taxpayer after receipt of the certification that the property is a qualifying brownfield property for goods and services necessary to obtain the remediation certification; and (3) expenditures to obtain remediation cost-cap or stop-loss coverage, re-opener or regulatory action coverage, or similar coverage under environmental insurance policies,<sup>224</sup> or to obtain financial guarantees required to manage the remediation and monitoring of the property. Eligible remediation expenditures include expenditures to: (1) manage, remove, control, contain, abate, or otherwise remediate a hazardous substance, pollutant, or contaminant on the property; (2) obtain a Phase II environmental site assessment of the property, including any expenditure to monitor, sample, study, assess, or otherwise evaluate the release, threat of release, or presence of a hazardous substance, pollutant, or contaminant on the property; or (3) obtain environmental regulatory certifications and approvals required to manage the remediation and monitoring of the hazardous substance, pollutant, or contaminant on the property. Eligible remediation expenditures do not include: (1) any portion of the purchase price paid or incurred by the eligible taxpayer to acquire the qualifying brownfield property; (2) environmental insurance costs paid or incurred to obtain legal defense coverage, owner/operator liability coverage, lender liability coverage, professional liability coverage, or similar types of coverage;<sup>225</sup> (3) any amount paid or incurred to the extent such amount is reimbursed, funded or otherwise subsidized by: (a) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the property; (b) proceeds of an issue of State or local government obligations used to provide

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<sup>223</sup> For these purposes, substantial completion means any necessary physical construction is complete, all immediate threats have been eliminated, and all long-term threats are under control.

<sup>224</sup> Cleanup cost-cap or stop-loss coverage is coverage that places an upper limit on the costs of cleanup that the insured may have to pay. Re-opener or regulatory action coverage is coverage for costs associated with any future government actions that require further site cleanup, including costs associated with the loss of use of site improvements.

<sup>225</sup> For this purpose, professional liability insurance is coverage for errors and omissions by public and private parties dealing with or managing contaminated land issues, and includes coverage under policies referred to as owner-controlled insurance. Owner/operator liability coverage is coverage for those parties that own the site or conduct business or engage in cleanup operations on the site. Legal defense coverage is coverage for lawsuits associated with liability claims against the insured made by enforcement agencies or third parties, including by private parties.

financing for the property, the interest of which is exempt from tax under section 103; or (c) subsidized financing provided (directly or indirectly) under a Federal, State, or local program in connection with the property; or (4) any expenditure paid or incurred before the date of enactment of the provision.

#### Qualified gain or loss

Section 512(b)(19) generally excludes from unrelated business taxable income the exempt organization's gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property. Income, gain, or loss from other transfers does not qualify under the provision.<sup>226</sup> The amount of gain or loss excluded from unrelated business taxable income is not limited to or based upon the increase or decrease in value of the property that is attributable to the taxpayer's expenditure of eligible remediation expenditures. Further, the exclusion does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including any amount deducted as a section 198 expense that is subject to the recapture rules of section 198(e), if the taxpayer had deducted such amount in the computation of its unrelated business taxable income.<sup>227</sup>

#### Special rules for qualifying partnerships

In the case of a tax-exempt organization that is a partner of a qualifying partnership that acquires, remediates, and disposes of a qualifying brownfield property, the provision applies to the tax-exempt partner's distributive share of the qualifying partnership's gain or loss from the disposition of the property.<sup>228</sup> A qualifying partnership is a partnership that: (1) has a partnership agreement that satisfies the requirements of section 514(c)(9)(B)(vi) at all times beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property; (2) satisfies the requirements of the provision if such requirements are applied to the partnership (rather than to the eligible taxpayer that is a partner of the partnership); and (3) is not an organization that would be prevented from constituting an eligible taxpayer by reason of it or an affiliate being potentially liable under CERCLA with respect to the property.

The exclusion is available to a tax-exempt organization with respect to a particular property acquired, remediated, and disposed of by a qualifying partnership only if the exempt organization is a partner of the partnership at all times during the period beginning on the date of

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<sup>226</sup> For example, rent income from leasing the property does not qualify.

<sup>227</sup> Depreciation or section 198 amounts that the taxpayer had not used to determine its unrelated business taxable income are not treated as gain that is ordinary income under sections 1245 or 1250 (secs. 1.1245-2(a)(8) and 1.1250-2(d)(6)), and are not recognized as gain or ordinary income upon the sale, exchange, or disposition of the property. Thus, an exempt organization would not be entitled to a double benefit resulting from a section 198 expense deduction and the proposed exclusion from gain with respect to any amounts it deducts under section 198.

<sup>228</sup> The exclusions do not apply to a tax-exempt partner's gain or loss from the tax-exempt partner's sale, exchange, or other disposition of its partnership interest. Such transactions continue to be governed by prior law.

the first certification received by the partnership that one of its properties is a qualifying brownfield property, and ending on the date of the disposition of the property by the partnership.

If the property is acquired and remediated by a qualifying partnership of which the exempt organization is a partner, it is intended that the certification as to status as a qualified brownfield property and the remediation certification will be obtained by the qualifying partnership, rather than by the tax-exempt partner, and that both the eligible taxpayer and the qualifying partnership will be required to make available such copies of the certifications to the IRS. Any elections or revocations regarding the application of the eligible remediation expenditure rules to multiple properties (as described below) acquired, remediated, and disposed of by a qualifying partnership must be made by the partnership. A tax-exempt partner is bound by an election made by the qualifying partnership of which it is a partner.

#### Special rules for multiple properties

The eligible remediation expenditure determinations generally are made on a property-by-property basis. An exempt organization (or a qualifying partnership of which the exempt organization is a partner) that acquires, remediates, and disposes of multiple qualifying brownfield properties, however, may elect to make the eligible remediation expenditure determinations on a multiple-property basis. In the case of such an election, the taxpayer satisfies the eligible remediation expenditures test with respect to all qualifying brownfield properties acquired during the election period if the average of the eligible remediation expenditures for all such properties exceeds the greater of: (a) \$550,000; or (b) 12 percent of the average of the fair market value of the properties, determined as of the dates they were acquired by the taxpayer and as if they were not contaminated. If the eligible taxpayer elects to make the eligible remediation expenditure determination on a multiple property basis, then the election shall apply to all qualifying sales, exchanges, or other dispositions of qualifying brownfield properties the acquisition and transfer of which occur during the period for which the election remains in effect.<sup>229</sup>

#### Debt-financed property

The present law provision provides that debt-financed property, as defined by section 514(b), does not include any property the gain or loss from the sale, exchange, or other disposition of which is excluded by reason of the provisions of the provision that exclude such gain or loss from computing the gross income of any unrelated trade or business of the taxpayer. Thus, gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property that otherwise satisfies the requirements of the provision is not taxed as unrelated business taxable income merely because the taxpayer incurred debt to acquire or improve the site.

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<sup>229</sup> If the taxpayer fails to satisfy the averaging test for the properties subject to the election, then the taxpayer may not apply the exclusion on a separate property basis with respect to any of such properties.

### Termination date

As noted above, only gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009, is eligible for the special exclusion. Property acquired during the five-year acquisition period need not be disposed of by the termination date in order to qualify for the exclusion. For purposes of the multiple property election, gain or loss on property acquired after December 31, 2009, is not eligible for the exclusion from unrelated business taxable income, although properties acquired after the termination date (but during the election period) are included for purposes of determining average eligible remediation expenditures.

### **Explanation of Provision**

The provision extends the special exclusion from unrelated business taxable income to properties acquired by an eligible taxpayer or qualifying partnership before January 1, 2011.

### **Effective Date**

The provision is effective for property acquired after December 31, 2009.

## **20. Real estate investment trust timber provisions (sec. 260 of the bill and secs. 856 and 857 of the Code)**

### **Present Law**

#### **Real estate investment trusts**

##### 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. 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;<sup>230</sup> 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 5 or fewer individual shareholders (as determined using specified attribution rules). A REIT must generally have a calendar year annual accounting period.<sup>231</sup> Other requirements also apply.<sup>232</sup>

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<sup>230</sup> Even if a REIT meets the 90 percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met to avoid an excise tax under section 4981.

<sup>231</sup> Sec. 859. There is an exception for certain REITs in existence prior to October 4, 1976.

<sup>232</sup> 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.<sup>233</sup>

#### Certain income tests

A REIT generally is restricted to earning certain types of passive income. Among other requirements, at least 75 percent of the gross income of a REIT in a taxable year (the 75-percent income test) must consist of certain types of real estate related income, including rents from real property; income from the sale or exchange of real property (including interests in real property) that is not property described in section 1221(a)(1) (stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business);<sup>234</sup> interest on mortgages secured by real property or interests in real property; and certain amounts received or accrued for entering into contracts to make loans secured by mortgages on real property or interests in real property, or to purchase or lease real property (including interests in real property and interests in mortgages on real property).<sup>235</sup> In addition, at least 95 percent of REIT gross income (the 95-percent income test) must be derived from sources that include the 75-percent income test sources plus other sources including interest, dividends, or gain from the sale or other disposition of stock or securities that are not property described in section 1221(a)(1) (stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business).<sup>236</sup> Interests in real property are generally specifically defined to exclude mineral, oil, or gas royalty interests.<sup>237</sup> However, under the Food, Conservation, and Energy Act of 2008,<sup>238</sup> for the first taxable year of a REIT beginning after May 22, 2008,<sup>239</sup> if the REIT is a “timber REIT” (defined as a REIT in which

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<sup>233</sup> 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).

<sup>234</sup> Sec. 856(c)(3)(C) and sec. 1221(a)(1). Gain from the sale of section 1221(a)(1) property is qualified income, however, if it is gain from the sale of a real estate asset which is not a prohibited transaction solely by reason of the prohibited transaction safe harbor of section 857(b)(6). See sec. 856(c)(3)(H).

<sup>235</sup> Section 856(c)(3).

<sup>236</sup> Sec. 856(c)(2)(D) and sec. 1221(a)(1). Gain from the sale of section 1221(a)(1) property is qualified income, however, if it is gain from the sale of a real estate asset which is not a prohibited transaction solely by reason of the prohibited transaction safe harbor of section 857(b)(6). See sec. 856(c)(2)(H).

<sup>237</sup> Section 856(c)(5)(C).

<sup>238</sup> H.R. 2419, Pub. L. No. 110-234, enacted on May 22, 2008 and reenacted in H.R. 6124, Pub. L. No. 110-246, to correct certain unrelated technical deficiencies, with the original effective date for the provisions discussed here.

<sup>239</sup> May 22, 2008 is the date of enactment of the Food, Conservation, and Energy Act of 2008. See immediately preceding footnote.



more than 50 percent of the value of its total assets consists of real property held in connection with the trade or business of producing timber), then mineral royalty income from real property owned by the timber REIT and held, or once held, in connection with the trade or business of producing timber by such REIT, is included as qualifying income for purposes of the REIT 95-percent income test (but not for purposes of the 75-percent income test).<sup>240</sup>

#### Certain asset tests

In addition to other asset tests, a REIT is not generally permitted to hold securities representing more than 10 percent of the voting power or value of the securities of any one issuer; nor may more than 5 percent of the fair market value of REIT assets be securities of any one issuer.<sup>241</sup> However, under an exception, a REIT may hold any amount of securities of one or more taxable REIT subsidiary (“TRS”) corporations, provided that such TRS securities do not represent more than 25 percent of the fair market value of REIT assets at the end of any quarter.<sup>242</sup> A TRS is a C corporation that is subject to regular corporate tax on its income and that meets certain other requirements. A taxable REIT subsidiary may conduct activities that would produce disqualified non-passive or non-real estate income that could disqualify the REIT if conducted by a REIT itself. Such business could include business relating to processing timber, or holding timber products or other assets for sale to customers in the ordinary course of business. Such income would be subject to regular corporate rates of tax as income of the TRS.<sup>243</sup>

#### Prohibited transactions tax

REITs are subject to a prohibited transaction tax (“PTT”) of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property described in section 1221(a)(1) (stock in trade, inventory, or property held by the taxpayer primarily for sale for sale to customers in the ordinary course of its trade or business)” that is not foreclosure property.<sup>244</sup> The PTT for a REIT does not apply to a

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<sup>240</sup> Sections 856(c)(2)(I) and 856(c)(5)(I).

<sup>241</sup> Section 856(c)(4)(B)(iii). Certain interests are not treated as “securities” for purposes of the rule forbidding the REIT to hold securities representing more than 10 percent of the value of securities of any one issuer. Sec. 856(m).

<sup>242</sup> Sec. 856(c)(4)(B)(ii) and (iii). Prior to enactment of the Food, Conservation and Energy Act of 2008, the limit on REIT ownership of TRS securities was 20 percent of the fair market value of REIT assets. For timber REITs, that Act changed that 20-percent limit to 25-percent, in the case of periods closing before the last day of the first taxable year of the timber REIT beginning after May 22, 2008 and before May 22, 2009. The Housing and Economic Recovery Act of 2008 (H.R. 3221, P.L. 110- 289) applied the 25-percent limit to all REITs and made the provision permanent.

<sup>243</sup> A 100-percent excise tax is imposed on the amount of certain transactions involving a TRS and a REIT, to the extent such amount would exceed an arm’s length amount under section 482. Sec. 857(b)(7).

<sup>244</sup> Sec. 897(b)(6)(B)(iii). This type of income also is not qualified income for purposes of the 75-percent or 95-percent income tests, unless it is excluded from the PTT solely by reason of the safe harbors under section 857(b)(6)(C) or 857(b)(6)(D).

sale if the REIT satisfies certain safe harbor requirements in sections 857(b)(6)(C) (applicable to real estate assets generally) or 857(b)(6)(D) (applicable to real estate assets held in connection with the trade or business of producing timber), including an asset holding period of at least 2 years.<sup>245</sup> If the conditions are met, a REIT may either (1) make no more than 7 sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell no more than 10 percent of the aggregate bases or fair market value of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.

Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property,<sup>246</sup> generally require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person. However, under the Food, Conservation, and Energy Act of 2008, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, for purposes of the timber property safe harbor under section 856(b)(6)(D), the marketing may be done by a taxable REIT subsidiary.<sup>247</sup>

For the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, in the case of a sale of property that is not a prohibited transaction through the application of section 857(b)(6)(D) (as in effect immediately prior to the enactment of the Housing and Economic Recovery Act of 2008, as modified by section 856(b)(6)(G) then in effect), the sale is

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<sup>245</sup> Prior to enactment of the Food, Conservation, and Energy Act of 2008, the required holding period was 4 years. That Act reduced the holding period to 2 years, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, but only in the case of timber property under section 857(b)(6)(D) (not in the case of property under section 857(b)(6)(C)) and then only if that timber property were sold to a qualified conservation organization for qualified conservation purposes (as those terms are defined in section 170(h)(3) and 170(h)(1)(C), respectively). The Housing and Economic Recovery Act of 2008, (H.R. 3221, Pub. L. 110-289) reduced the holding period to 2 years on a permanent basis, for both sections 857(b)(6)(C) and 857(b)(6)(D), applicable to all REITs and without the requirement of a sale to a qualified conservation organization for qualified conservation purposes. The remaining impact of the Food, Conservation and Energy Act of 2008 PTT safe harbor provision, which expires at the end of the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, is the rule that if the sale qualifies for the 857(b)(6)(D) safe harbor (as in effect immediately prior to enactment of the Housing and Economic Recovery Act of 2008, as modified by the rule then in effect for property held at least 2 years and sold to a qualified conservation organization for qualified conservation purposes), then the sale is treated for all purposes of the Code as a sale of property held for investment or for use in a trade or business and not property described in section 1221(a)(1). See secs. 857(b)(6)(G) and 857(b)(6)(H).

<sup>246</sup> Prior to enactment of the Food, Conservation, and Energy Act of 2008, the required measurement period was 4 years. That Act reduced the holding period to 2 years, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, but only in the case of property held in connection with the trade or business of producing timber under section 857(b)(6)(D) (not in the case of property under section 857(b)(6)(C), and then only if such timber property were sold to a qualified conservation organization for qualified conservation purposes (as those terms are defined in section 170(h)(3) and 170(h)(1)(C), respectively). The Housing and Economic Recovery Act of 2008 reduced the measurement period to 2 years on a permanent basis, for both sections 857(b)(6)(C) and 857(b)(6)(D), applicable to all REITs and without the requirement of a sale to a qualified conservation organization for qualified conservation purposes.

<sup>247</sup> Sec. 857(b)(6)(C) (v) and section 857(b)(6)(D)(v).

treated as a sale of property held for investment or for use in a trade or business and not property described in section 1221(a)(1) for all purposes of the Code. Section 857(b)(6)(D) as so in effect at the referenced time contained the rule of then section 856(b)(6)(G), permitting property held at least 2 years and otherwise qualifying for the safe harbor to qualify for the safe harbor if it is sold to a qualified conservation organization for qualified conservation purposes (as those terms are defined in sections 170(h)(3) and 170(h)(1)(C), respectively).<sup>248</sup>

#### REITs engaged in timber activities

If a taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)). The fair market value of the timber on the first day of the taxable year in which the timber is cut is used to determine the gain attributable to such cutting. Such fair market value is also considered the taxpayer's cost of the cut timber for all purposes, such as to determine the taxpayer's income from later sales of the timber or timber products. Also, if a taxpayer disposes of the timber with a retained economic interest or makes an outright sale of the timber, the gain is eligible for capital gain treatment (sec. 631(b)). This treatment under either section 631(a) or 631(b) requires that the taxpayer has owned the timber or held the contract right for a period of more than one year.

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The IRS has issued private letter rulings in particular instances stating that the income from the sale of the trees under section 631(b) can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.<sup>249</sup>

Under the Food, Conservation, and Energy Act of 2008, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, the Code specifically includes timber gain under section 631(a) as a category of statutorily recognized qualified real estate income of a REIT if the cutting is provided by a taxable REIT subsidiary, and also includes gain recognized under section 631(b). For purposes of such qualified income treatment under those provisions, the requirement of a one-year holding period is removed. Thus, for example, a REIT can acquire timber property and harvest the timber on the property within one year of the acquisition, with the resulting income being qualified real estate income for REIT qualification purposes, even though such income is not eligible for long-term capital gain treatment under sections 631(a) or 631(b). The temporary Code rule specifically provides, however, that for all purposes of the Code, such income shall not be considered to be gain described in section 1221(a)(1), that is, it shall not be treated as income from the sale of stock in trade, inventory, or

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<sup>248</sup> If the sale was not to a qualified conservation organization for qualified conservation purposes, a 4-year holding period was required, and the limits on certain expenditures were computed by reference to a 4-year period.

<sup>249</sup> Timber income under section 631(b) has also been held to be qualified real estate income even if the one-year holding period is not met. See, e.g., PLR 200052021, *see also* PLR 199945055, PLR 199927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice.

property held by the REIT primarily for sale to customers in the ordinary course of the REIT's trade or business. In addition, for such first taxable year, the Code specifically provides that for purposes of determining REIT income, if the cutting is done by a taxable REIT subsidiary, the cut timber is deemed sold on the first day of the taxable year to the taxable REIT subsidiary (with subsequent gain, if any, attributable to the taxable REIT subsidiary).

### **Explanation of Provision**

The provision extends all of the otherwise expiring REIT timber provisions that were enacted in the Food, Conservation, and Energy Act of 2008, through the end of any taxable year beginning on or before December 31, 2010.<sup>250</sup>

### **Effective Date**

The provision is effective for REIT taxable years ending after May 22, 2009.

## **21. Treatment of certain dividends of regulated investment companies (sec. 261 of the bill and sec. 871(k) of the Code)**

### **Present Law**<sup>251</sup>

#### **In general**

A regulated investment company ("RIC") is an entity that meets certain requirements, including a requirement that its income generally be derived from passive investments such as dividends and interest, that it distribute 90 percent of its income, and that elects to be taxed under a special tax regime. Unlike an entity taxed as a corporation, an entity that is taxed as a RIC can deduct amounts paid to its shareholders as dividends. In this manner, tax on RIC income is generally not paid by the RIC but rather by its shareholders. However, income of a RIC is treated as a dividend by those shareholders, unless other special rules apply. Dividends received by foreign persons from a RIC are generally subject to gross-basis tax under sections 871(a) or 881, and the RIC payor of such dividends is obligated to withhold such tax under sections 1441 and 1442.

Under present law, a RIC that earns certain interest income that would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally can treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had earned the interest directly. Also, subject to certain requirements, the RIC is exempt

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<sup>250</sup> In connection with the extension of the provision treating mineral royalty income of a timber REIT as qualifying income for purposes of the REIT 95-percent income test (provided such income is from real property owned by the timber REIT and held, or once held, in connection with the trade or business of producing timber by such REIT), it is clarified that mineral royalty income for this purpose is intended to include oil or gas royalty income.

<sup>251</sup> Secs. 871(k), 881, 1441 and 1442.

from withholding the gross basis tax on such dividends. Similar rules apply with respect to the designation of certain short term capital gain dividends. However, these provisions relating to certain dividends with respect to interest income and short term capital gain of the RIC do not apply to dividends with respect to any taxable year of a RIC beginning after December 31, 2009.

### **Explanation of Provision**

The provision extends the rules exempting from gross basis tax and from withholding tax the interest-related dividends and short term capital gain dividends received from a RIC, to dividends with respect to taxable years of a RIC beginning before January 1, 2011.

### **Effective Date**

The provision applies to dividends paid with respect to any taxable year of the RIC beginning after December 31, 2009.

## **22. Treatment of RICs as “qualified investment entities” under section 897 (FIRPTA) (sec. 262 of the bill and sec. 897 of the Code)**

### **Present law**

Special U.S. tax rules apply to capital gains of foreign persons that are attributable to dispositions of interests in U.S. real property. In general, although a foreign person (a foreign corporation or a nonresident alien individual) is not generally taxed on U.S. source capital gains unless certain personal presence or active business requirements are met, a foreign person who sells a U.S. real property interest (“USRPI”) is subject to tax at the same rates as a U.S. person, under the Foreign Investment in Real Property Tax Act (“FIRPTA”) provisions codified in section 897 of the Code. Withholding tax is also imposed under section 1445.

A USRPI includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation (as defined) during the testing period. A USRPI does not include an interest in a domestically controlled “qualified investment entity.” A distribution from a “qualified investment entity” that is attributable to the sale of a USRPI is also subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United States and the recipient foreign corporation or nonresident alien individual did not hold more than 5 percent of that class of stock or beneficial interest within the 1-year period ending on the date of distribution. Special rules apply to situations involving tiers of qualified investment entities.

The term “qualified investment entity” includes a regulated investment company (“RIC”) that meets certain requirements, although the inclusion of a RIC in that definition is scheduled to expire, for certain purposes, on December 31, 2009.<sup>252</sup>

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<sup>252</sup> Section 897(h).

### **Explanation of Provision**

The provision extends the inclusion of a RIC within the definition of a “qualified investment entity” under section 897 of the Code through December 31, 2010, for those situations in which that inclusion would otherwise expire at the end of 2009.

### **Effective Date**

The provision is generally effective on January 1, 2010.

However, the provision does not apply to impose a withholding requirement under section 1445 that would not otherwise be imposed but for the provision, for any payment made before the date of enactment. A regulated investment company that makes a distribution after December 31, 2009 and before the date of enactment which would, but for that exception, have been required to withhold under section 1445, shall not be liable to any person to whom such distribution was made for any amount so withheld and paid over to the Secretary of the Treasury.

### **23. Subpart F exception for active financing income (sec. 263 of the bill and secs. 953 and 954 of the Code)**

#### **Present Law**

Under the subpart F rules,<sup>253</sup> 10-percent-or-greater 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. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

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.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC’s country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with

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<sup>253</sup> Secs. 951-964.

risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.<sup>254</sup>

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, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income"). These provisions were enacted in the Taxpayer Relief Act of 1997 as one-year temporary exceptions, and in 1998, 1999, 2002, 2006, and 2008, the provisions were extended, and in some cases, modified.<sup>255</sup>

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU

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<sup>254</sup> Prop. Treas. Reg. sec. 1.953-1(a).

<sup>255</sup> Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277). The Tax Relief Extension Act of 1999 (Pub. L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009. The Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) extended the temporary provisions for one year, for taxable years beginning after 2008 and before 2010.

in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

### **Explanation of Provision**

The provision extends for one year (for taxable years beginning before 2011) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income 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.

### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.



## **24. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company rules (sec. 264 of the bill and sec. 954(c)(6) of the Code)**

### **Present Law**

#### **In general**

The rules of subpart F<sup>256</sup> require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (“CFC”) to include certain income of the CFC (referred to as “subpart F income”) on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income of a CFC does not include any item of income from sources within the United States that is effectively connected with the conduct by such CFC of a trade or business within the United States (“ECI”) unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

#### **The “look-through rule”**

Under the “look-through rule” (sec. 954(c)(6)), dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as ECI. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC’s stock (by vote or value) constitutes control for these purposes.

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-through rule, including such regulations as are appropriate to prevent the abuse of the purposes of such rule.

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<sup>256</sup> Secs. 951-964.

The look-through rule is effective for taxable years of foreign corporations beginning before January 1, 2010, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

### **Explanation of Provision**

The provision extends for one year the application of the look-through rule, to taxable years of foreign corporations beginning before January 1, 2011, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

## **25. Basis adjustment to stock of S corporations making charitable contributions of property (sec. 265 of the bill and sec. 1367 of the Code)**

### **Present Law**

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.<sup>257</sup> A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.<sup>258</sup>

In the case of contributions made in taxable years beginning before January 1, 2010, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2009, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

### **Explanation of Provision**

The provision extends the rule relating to the basis reduction on account of charitable contributions of property for one year to contributions made in taxable years beginning before January 1, 2011.

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<sup>257</sup> Sec. 1366(a)(1)(A).

<sup>258</sup> Sec. 1367(a)(2)(B).

### Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2009.

### **26. Empowerment zone tax incentives (sec. 266 of the bill and secs. 1391 and 1202 of the Code)**

#### Present Law

The Omnibus Budget Reconciliation Act of 1993 (“OBRA 93”)<sup>259</sup> authorized the designation of nine empowerment zones (“Round I empowerment zones”) to provide tax incentives for businesses to locate within certain targeted areas<sup>260</sup> 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<sup>261</sup> 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”)<sup>262</sup> authorized a total of ten new empowerment zones (“Round III empowerment zones”), bringing the total number of authorized empowerment zones to 40.<sup>263</sup> 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.<sup>264</sup>

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<sup>259</sup> Pub. L. No. 103-66.

<sup>260</sup> 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.

<sup>261</sup> Pub. L. No. 105-34.

<sup>262</sup> Pub. L. No. 106-554.

<sup>263</sup> 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.

<sup>264</sup> 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.

The tax incentives available within the designated empowerment zones 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 following is a description of the tax incentives that are currently all scheduled to expire as of December 31, 2009.

### **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.<sup>265</sup>

The wage credit rate applies to qualifying wages paid before January 1, 2010. 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.”<sup>266</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>267</sup> 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.<sup>268</sup> 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.<sup>269</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>270</sup>

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<sup>265</sup> 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.

<sup>266</sup> 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.

<sup>267</sup> Sec. 280C(a).

<sup>268</sup> Secs. 1396(c)(3)(A) and 51A(d)(2).

<sup>269</sup> Secs. 1396(c)(3)(B) and 51A(d)(2).

<sup>270</sup> 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 \$285,000 in 2009 and \$169,000 in 2010<sup>271</sup>) for qualified zone property placed in service before January 1, 2010.<sup>272</sup> 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 \$500,000.<sup>273</sup> 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.<sup>274</sup>

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

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<sup>271</sup> Note that if the Section 179 limitation is extended by this legislation, the 2010 amount will be \$285,000.

<sup>272</sup> Secs. 1397A, 1397D.

<sup>273</sup> Sec. 1397A(a)(2), 179(b)(2), (7). For 2008 and 2009, the limit is \$800,000.

<sup>274</sup> Sec. 1397C(b).

percent of such employees are residents of an empowerment zone; (6) less than 5 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 5 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.<sup>275</sup>

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.<sup>276</sup> 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.<sup>277</sup> 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).<sup>278</sup>

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

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<sup>275</sup> Sec. 1397C(c).

<sup>276</sup> 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).

<sup>277</sup> Sec. 1394.

<sup>278</sup> Sec. 1394(b)(3).

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.

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<sup>279</sup> held for more than one year and replaced within 60 days by another qualified empowerment zone asset in the same zone.<sup>280</sup> 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**

For taxpayers other than corporations, 50 percent of the gain from the sale of qualified small business stock held for more than five years is excluded from gross income.<sup>281</sup> In the case of qualified small business stock acquired after December 21, 2000, in a corporation which is a qualified business entity (as defined in section 1397C(b)) during substantially all of the taxpayer's holding period, the exclusion is increased to 60 percent.<sup>282</sup> The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.<sup>283</sup>

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<sup>279</sup> 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 274. For the definition of "qualified business," see text accompanying *supra* note 274.

<sup>280</sup> Sec. 1397B.

<sup>281</sup> Sec. 1202.

<sup>282</sup> The increased exclusion does not apply to gain attributable to periods after December 31, 2014.

<sup>283</sup> Sec. 1(h).

A percentage of the excluded gain is an alternative minimum tax preference;<sup>284</sup> the portion of the gain includible in alternative minimum taxable income (“AMTI”) is taxed at a maximum rate of 28 percent under the 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.

For all qualified small business stock acquired after February 17, 2009, and before January 1, 2011, the exclusion 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<sup>285</sup> and 12.88 percent under the AMT.<sup>286</sup>

### **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.

### **Explanation of Provision**

The provision extends for one year, through December 31, 2010, the period for which the designation of an empowerment zone is in effect, thus extending for one year 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.

The provision extends for one year, through December 31, 2015, the period for which gain from the sale or exchange of qualified business stock held for more than five years is excluded from gross income.

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<sup>284</sup> 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.

<sup>285</sup> The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>286</sup> The 46 percent of gain included in AMTI is 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).



### **Effective Date**

The provision relating to the designation of an empowerment zone and the provision relating to the exclusion of gain from the sale or exchange of qualified small business stock held for more than five years applies to periods after December 31, 2009.

### **27. Tax incentives for investment in the District of Columbia (sec. 267 of the bill and secs. 1400, 1400A, 1400B, and 1400C of the Code)**

### **Present Law**

#### **In general**

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,” 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, 2009.

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, 2010. 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 \$285,000 in 2009) for qualified zone property placed in service after December 31, 2001, and before January 1, 2010. 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 \$500,000. 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 5 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 5 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 5 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.

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, 2009.

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, 2014, 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.

### **Explanation of Provision**

The provision extends for one year, through December 31, 2010, the designation of the District of Columbia Enterprise Zone. The provision also extends for one year through December 31, 2010, the special \$15 million per--user bond limitation and the relief from resident and employee requirements for certain tax-exempt bonds issued in the District of Columbia Enterprise Zone.

The provision extends for one year the zero-percent capital gains rate applicable to capital gains from the sale or exchange of any DC Zone asset held for more than five years (and, as amended, acquired or substantially improved before January 1, 2011). The provision also extends for one year the period to which the term “qualified capital gain” refers. As amended, the term “qualified capital gain” shall not include any gain attributable to periods before January 1, 1998, or after December 31, 2015.

The provision extends the first-time D.C. homebuyer credit for one year (as amended, to apply to property purchased before January 1, 2011).

### **Effective Date**

The provision extending the period of designation of the District of Columbia Enterprise Zone and the provision extending the period for which the term “qualified capital gain” refers applies to periods after December 31, 2009. The provision extending tax-exempt financing for certain zone facilities applies to bonds issued after December 31, 2009. The provision amending the definitions of DC Zone business stock, DC Zone partnership interest, and DC Zone business property applies to property acquired or substantially approved after December 31, 2009. The provision extending the first-time homebuyer credit applies to property purchased after December 31, 2009.

## **28. Renewal community tax incentives (sec. 268 of the bill and secs. 1400E, 1400F, 1400I, and 1400J of the Code)**

### **Present Law**

The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, authorized the designation of 40 “renewal communities” within which special Federal tax incentives are available to attract business and investment to distressed urban and rural areas. 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 Secretary of Housing and Urban Development has awarded renewal community designations to 40 selected communities (28 urban and 12 rural), including areas that remained distressed after previously having received empowerment zone or enterprise community designations.<sup>287</sup> To qualify as a renewal community, the community must have (1) a minimum unemployment rate of 9.45 percent (versus 6.3 percent for enterprise communities and empowerment zones) and (2) a minimum population of 4,000 within a metro area or 1,000 otherwise and a maximum population of 200,000. The designation of an area as a renewal community is effective on January 1, 2002, and terminates after December 31, 2009.<sup>288</sup>

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<sup>287</sup> The 28 urban renewal communities are: Mobile, AL; Los Angeles, San Diego, and San Francisco, CA; Atlanta, GA; Chicago, IL; New Orleans and Ouachita Parish, LA; Lawrence and Lowell, MA; Detroit and Flint, MI; Camden and Newark, NJ; Buffalo-Lackawanna, Niagara Falls, Rochester, and Schenectady, NY; Hamilton and Youngstown, OH; Philadelphia, PA; Charleston, SC; Chattanooga and Memphis, TN; Corpus Christi, TX; Tacoma and Yakima, WA; and Milwaukee, WI.

The 12 rural renewal communities are: Greene-Sumter, AL; Southern Alabama; Orange Cove and Parlier, CA; Eastern Kentucky; Central and Northern Louisiana; West-Central Mississippi; Turtle Mountain Band of Chippewa, ND; Jamestown, NY; El Paso County, TX; and Burlington, VT.

<sup>288</sup> Section 1400E(b)(1) provides that an area’s designation would have terminated earlier than December 31, 2009, if (1) an earlier termination date had been so designated by the State or local government in its nomination, or (2) the Secretary of HUD had revoked the designation as of an earlier date.

The tax incentives provided under the renewal communities program include a Federal income tax credit for employers who hire qualifying employees, enhanced tax deductions on qualifying equipment and expenditures to construct or rehabilitate certain nonresidential buildings, and capital gains tax exclusion on sales of qualified assets. The tax incentives for renewal communities generally are available through December 31, 2009.<sup>289</sup>

The following is a description of these tax incentives.

### **Renewal community employment credit**

A 15-percent wage credit is available to employers for the first \$10,000 of qualified wages paid to each employee (i.e., a maximum credit of \$1,500 with respect to each qualified employee) who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business of the employer.<sup>290</sup>

The wage credit applies to qualifying wages paid before January 1, 2010. Wages paid to a qualified employee who earns more than \$10,000 are eligible for the wage credit (although only the first \$10,000 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 renewal community may claim the wage credit, regardless of whether the employer meets the definition of a “renewal community business.”<sup>291</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>292</sup> 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.<sup>293</sup> In addition, the \$10,000 cap is reduced by any wages taken into account in computing the work opportunity tax

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<sup>289</sup> If a renewal community designation is terminated prior to December 31, 2009, the tax incentives cease to be available as of the termination date.

<sup>290</sup> Sec. 1400H. This section treats a renewal community as an empowerment zone for purposes of section 1396 with respect to wages paid or incurred after December 31, 2001, subject to modifications of the applicable percentage amount (15 percent instead of 20 percent) and the qualified wage amount (\$10,000 instead of \$15,000).

<sup>291</sup> Sec. 1400G. However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than 5 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.

<sup>292</sup> Sec. 280C(a).

<sup>293</sup> Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

credit or the welfare-to-work credit.<sup>294</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>295</sup>

### **Additional section 179 expensing**

A renewal community business (as defined below in connection with the zero-percent capital gains rate) is allowed an additional \$35,000 of section 179 expensing for qualified renewal property placed in service before January 1, 2010.<sup>296</sup> The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds \$500,000.<sup>297</sup>

The term “qualified renewal property” is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the renewal community commences with the taxpayer, and (3) substantially all of the use of the property is in the renewal community in the active conduct of a trade or business by the taxpayer.<sup>298</sup> Special rules are provided in the case of property that is substantially renovated by the taxpayer.

### **Commercial revitalization deduction**

Each State is permitted to allocate up to \$12 million of commercial revitalization expenditures to each renewal community located within the State for each calendar year after 2001 and before 2010. The appropriate State agency will make the allocations pursuant to a qualified allocation plan.<sup>299</sup>

A commercial revitalization expenditure means the cost of a new building or the cost of substantially rehabilitating an existing building. The building must be used for commercial purposes and be located in a renewal community. In the case of the rehabilitation of an existing building, the cost of acquiring the building will be treated as a qualifying expenditure only to the extent that such costs do not exceed 30 percent of the other rehabilitation expenditures. The qualifying expenditures for any building cannot exceed \$10 million.

A taxpayer can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service or (b) amortize all the expenditures ratably over the 120-month period beginning with the month the building is placed

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<sup>294</sup> Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

<sup>295</sup> Sec. 38(c)(2).

<sup>296</sup> Sec. 1400J.

<sup>297</sup> Sec. 1400J, 179(b)(2), 179(b)(7). For 2008 and 2009, the limit is \$800,000.

<sup>298</sup> Secs. 1400J(b), 1397D.

<sup>299</sup> Sec. 1400I.

in service.<sup>300</sup> No depreciation is allowed for amounts deducted under this provision. The adjusted basis of the building is reduced by the amount of the commercial revitalization deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules.

The commercial revitalization deduction is treated in the same manner as the low-income housing credit in applying the passive loss rules. Thus, up to \$25,000 of deductions (together with the other deductions and credits not subject to the passive loss limitation by reason of section 469(i)) are allowed to an individual taxpayer regardless of the taxpayer's adjusted gross income. The commercial revitalization deduction is allowed in computing a taxpayer's alternative minimum taxable income.

### **Zero-percent capital gains rate**

A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years.<sup>301</sup> A qualified community asset includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

A renewal community business is defined as a corporation or partnership (or proprietorship) if for the taxable year (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business<sup>302</sup> within a renewal community; (2) at least 50 percent of the total gross income is derived from the active conduct of a "qualified business" within a renewal community; (3) a substantial portion of the business's tangible property is used within a renewal community; (4) a substantial portion of the business's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a renewal community; (6) at least 35 percent of the employees are residents of the renewal community; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Property will continue to be a

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<sup>300</sup> Sec. 1400I.

<sup>301</sup> Sec. 1400F.

<sup>302</sup> 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. In addition, the leasing of real property that is located within the renewal community 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 renewal community 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 a renewal community.



qualified community asset if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or tangible property used in) a renewal community business.

The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, is not eligible for the zero-percent rate.

### **Other tax incentives**

Other incentives not specific to renewal communities 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 renewal community residents (up to \$2,400 per employee), and qualified zone academy bonds for certain public schools expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced-cost lunches.

### **Explanation of Provision**

The provision extends for one year, through December 31, 2010, the period for which the designation of a renewal community is in effect.

The provision extends for one year, through January 1, 2011, the period for which the taxpayer can acquire a qualified community asset defined to include qualified community stock, a qualified community partnership interest, and qualified community business property. The provision extends for one year, through December 31, 2015, the period for which qualified capital gain from the sale or exchange of a qualified community asset held for more than five years is excluded from gross income.

The provision extends for one year, through December 31, 2010, the period for which a taxpayer can place a qualified revitalization building in service for purposes of the commercial revitalization deduction.

The provision extends for one year, through December 31, 2010, the period through which the taxpayer can acquire qualified renewal property.

### **Effective Date**

The provision relating to the designation of a renewal community and the provision relating to the exclusion of gain from the sale or exchange of a qualified community asset held for more than five years applies to periods after December 31, 2009. The provision relating to the period for which the taxpayer can acquire a qualified community asset or qualified renewal property applies to acquisitions after December 31, 2009. The provision relating to the placed in service date for qualified revitalization buildings eligible for the commercial revitalization deduction applies to buildings placed in service after December 31, 2009.

## **29. Temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands (sec. 269 of the bill and sec. 7652(f) of the Code)**

### **Present Law**

A \$13.50 per proof gallon<sup>303</sup> excise tax is imposed on distilled spirits produced in or imported into the United States.<sup>304</sup> The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).<sup>305</sup>

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.<sup>306</sup> The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon before January 1, 2010).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.<sup>307</sup> Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.<sup>308</sup> All of the amounts covered over are subject to the limitation.

### **Explanation of Provision**

The provision suspends for one year the \$10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over limitation of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2009 and before January 1, 2011. After December 31, 2010, the cover over amount reverts to \$10.50 per proof gallon.

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<sup>303</sup> A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

<sup>304</sup> Sec. 5001(a)(1).

<sup>305</sup> Secs. 5214(a)(1)(A), 5002(a)(15), 7653(b) and (c).

<sup>306</sup> Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

<sup>307</sup> Sec. 7652(e)(2).

<sup>308</sup> Secs. 7652(a)(3), (b)(3), and (e)(1).

### **Effective Date**

The provision is effective for articles brought into the United States after December 31, 2009.

### **30. Payment to American Samoa in lieu of extension of economic development credit (sec. 270 of the bill and sec. 119 of Pub. L. No. 109-432)**

#### **Present Law**

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006 is allowed a credit based on the corporation's economic activity-based limitation with respect to American Samoa. The credit is not part of the Code but is computed based on the rules of sections 30A and 936. The credit is allowed for the first four taxable years of a corporation that begin after December 31, 2005, and before January 1, 2010.

A corporation was an existing credit claimant with respect to a American Samoa if (1) the corporation was engaged in the active conduct of a trade or business within American Samoa on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit<sup>309</sup> in an election in effect for its taxable year that included October 13, 1995.<sup>310</sup> A corporation that added

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<sup>309</sup> For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit. Secs. 27(b), 936. This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions. Subject to certain limitations, discussed below, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment. No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under section 936.

Under the economic activity-based limit, the amount of the credit could not exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes. A taxpayer could elect, instead of the economic activity-based limit, a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income, beginning in 1998, the applicable percentage was 40 percent.

To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business. Sec. 936(a)(2). The section 936 credit generally expired for taxable years beginning after December 31, 2005.

<sup>310</sup> A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a possession on October 13, 1995, and

a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under section 936 does not apply with respect to the credit allowed by the provision.

The credit is not available for taxable years beginning after December 31, 2009.

### **Explanation of Provision**

The provision provides for a payment of \$18 million to the American Samoa Government for purposes of stimulating economic development in American Samoa. The payment is treated as a refund of internal revenue collections to which section 1324 of title 31 of the United States Code applies.

### **Effective Date**

The provision is effective on the date of enactment.

## **31. Election to temporarily utilize unused amt credits determined by domestic investment (sec. 271 of the bill and sec. 53 of the Code)**

### **Present Law**

#### **Minimum tax credits**

If a corporation is subject to the alternative minimum tax ("AMT") in any taxable year, the amount of AMT imposed is allowed as a credit ("minimum tax credit") in a subsequent taxable year to the extent the corporation's regular tax liability in the subsequent year exceeds its

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(2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

tentative minimum tax.<sup>311</sup> Minimum tax credits may be carried forward indefinitely until utilized.

### **Election to claim minimum tax credits in lieu of bonus depreciation**

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect, for its first taxable year ending after December 31, 2008 and each subsequent taxable year, to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for “extension property.”<sup>312</sup> “Extension property” is property that is eligible qualified property solely by reason of the extension of the additional first-year depreciation deduction pursuant to the amendments made by section 1201(a) of the American Recovery and Reinvestment Tax Act of 2009.<sup>313</sup> Eligible qualified property generally is property placed in service during 2009 (2010 in the case of certain longer-lived and transportation property) that is otherwise eligible for the additional first-year depreciation deduction.

A corporation making the election forgoes the depreciation deductions allowable under section 168(k) and instead increases the limitation under section 38(c) on the use of research credits or section 53(c) on the use of minimum tax credits.<sup>314</sup> The increase in the allowable credits is treated as refundable for purposes of this provision. 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 research credit or minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation<sup>315</sup> for certain eligible qualified property that could be claimed absent the election. The bonus depreciation amount is limited to the lesser of: (1) \$30 million, or (2) 6 percent of the sum of research credit carryforwards from taxable years beginning before January 1, 2006 and minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1,

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<sup>311</sup> Sec. 53.

<sup>312</sup> Sec. 168(k)(4). In the case of an electing corporation that is a partner in a partnership, the corporate partner’s distributive share of partnership items is determined as if section 168(k) does not apply to any eligible qualified property and the straight line method is used to calculate depreciation of such property.

<sup>313</sup> Pub. L. No. 111-5, the American Recovery and Reinvestment Tax Act of 2009, extended the additional first-year depreciation deduction to apply to qualified property acquired and placed in service after December 31, 2008 and before January 1, 2010 (January 1, 2011, for certain longer-lived and transportation property). See discussion above.

<sup>314</sup> Special rules apply to an applicable partnership.

<sup>315</sup> 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 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.

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.

### **Extended net operating loss carryback period**

A net operating loss (“NOL”) generally means the amount by which a taxpayer’s business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.<sup>316</sup> NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.<sup>317</sup>

With respect to a NOL for a single taxable year beginning or ending in either 2008 or 2009, a taxpayer generally may elect to increase the present-law carryback period for such NOL from two years to any whole number of years elected by the taxpayer which is more than two and less than six.<sup>318</sup> The amount of NOL that may be carried back to the fifth taxable year preceding the loss year is limited to 50 percent of taxable income for such taxable year (computed without regard to the NOL for the loss year or any taxable year thereafter).<sup>319</sup> The amount of the NOL otherwise carried to taxable years subsequent to such fifth taxable year is adjusted to take into account that the NOL could offset only 50 percent of the taxable income in such year.

### **Explanation of Provision**

A corporation may elect to increase the AMT liability limitation amount under section 53(c) for its first taxable year beginning after 2009<sup>320</sup> by the AMT credit adjustment amount. The AMT credit adjustment amount is an amount equal to the lesser of--(i) 50 percent of the taxpayer’s minimum tax credit determined under section 53(b) for the taxable year, or (ii) 10 percent of the taxpayer’s new domestic investment made during the taxable year.<sup>321</sup>

Under the provision, new domestic investment is the cost of qualified property (as defined in section 168(k)(2)(A)(i)),<sup>322</sup> the original use of which commences with the taxpayer

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<sup>316</sup> Sec. 172(b)(1)(A). Different carryback periods apply with respect to NOLs arising in certain special circumstances.

<sup>317</sup> Sec. 172(b)(2).

<sup>318</sup> Sec. 172(b)(1)(H).

<sup>319</sup> The limitation does not apply to the applicable 2008 NOL of an eligible small business with respect to which an election is made (either before or after the date of enactment of the bill) under the provision as presently in effect.

<sup>320</sup> The provision does not apply to any taxable year that begins after December 31, 2010.

<sup>321</sup> For all elections under this provision, the common parent of a group of corporations filing a consolidated return makes the election, which is binding on all such corporations.

<sup>322</sup> Sec. 168(k)(2)(A)(i) defines “qualified property” as property that--(1) has a recovery period of 20 years or less, (2) is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under

during the taxable year and which is placed in service in the United States by the taxpayer during such taxable year. A taxpayer that makes an election under this provision includes in its new domestic investments, its allocable share of any new domestic investments made by a partnership in which the taxpayer owns (directly or indirectly) more than 90 percent of the capital and profits interest at all times during the taxable year for which the election is in effect.

The amount of increase in the minimum tax credit allowed by reason of the election is treated as a refundable credit. The amount of the refundable credit is treated as a payment of estimated tax for purposes of the adjustment of overpayment of estimated taxes by a corporation under section 6425. However, the amount so treated is reduced (but not below zero) by the aggregate increase in tax liability resulting from the revocation of the corporation's election under section 172(b)(1)(H) that is unpaid as of the date the claim under section 6425 is filed.

A corporation (other than an eligible small business as defined in section 172(b)(1)(H)(v)(II)) making an election under this provision that previously made an election under section 172(b)(1)(H) to carryback an NOL for additional years is deemed to have revoked the NOL election.<sup>323</sup> To provide the IRS sufficient time to ensure that a corporation repays amounts previously refunded, the period for assessing any deficiency resulting from such revocation shall not expire before the end of the 3-year period beginning on the date of the election.

Within 90 days of the date of enactment, the Secretary is to provide guidance prescribing the time and manner for making the election. Once made, an election under this provision may be revoked only with prior consent of the Secretary.

The Secretary is authorized to issue regulations as necessary to carry out the provision, including to prevent fraud and abuse with respect to the provision.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2009.

## **32. Study of extended tax expenditures (sec. 272 of the bill)**

### **Present Law**

The Congressional Budget and Impoundment Control Act of 1974<sup>324</sup> ("the Budget Act") created the House and Senate Budget Committees and charged them with the duty "to request

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section 167(a) without regard to section 168(k)(2), (3) is water utility property, or (4) is qualified leasehold improvement property (defined in section 168(k)(3)).

<sup>323</sup> As a result of the deemed revocation, the corporation must redetermine its NOL and other carryovers as if the election under section 172(b)(1)(H) had not been made, and must repay any amounts refunded to it as a result of such election (unless the claim for refund under section 6425 has been reduced for such amount).

<sup>324</sup> Pub. L. No. 93-344.

and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies” to the respective chamber of Congress on a recurring basis. It defines tax expenditures as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”<sup>325</sup>

The Budget Act also created the Congressional Budget Office (“CBO”), and requires it to provide an annual report to Congress on “the levels of tax expenditures under existing law, taking into account projected economic factors and any changes in such levels based on provisions in the budget submitted by the President for such fiscal year.”<sup>326</sup> In light of the traditional expertise of the staff of the Joint Committee on Taxation (“JCT staff”) with respect to revenue matters, and a separate statutory requirement that Congress rely on JCT staff estimates when considering the revenue effects of proposed legislation,<sup>327</sup> the CBO has always relied on the JCT staff for the production of its annual tax expenditure publication.<sup>328</sup>

The Congressional Research Service (“CRS”) prepares a biennial publication<sup>329</sup> for the use of the Committee on the Budget of the United States Senate in support of the Budget Act mandate for the Budget Committees to examine tax expenditures as they develop the Congressional Budget Resolution. The publication includes for each provision its legal authorization, a description of the tax provision and its impact, the rationale at the time of adoption, an assessment, and bibliographic citations.

The U.S. Government Accountability Office (“GAO”) issues reports on tax expenditures from time to time in its role of supporting Congressional oversight of how taxpayer dollars are spent.<sup>330</sup>

### **Explanation of Provision**

The provision requires the Chief of Staff of the Joint Committee on Taxation, in consultation with the Comptroller General of the United States, to submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a

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<sup>325</sup> Pub. L. No. 93-344, sec. 3(3), codified at 2 USC 622(3).

<sup>326</sup> Pub. L. No. 93-344, sec. 202(f)(1)(B).

<sup>327</sup> Pub. L. No. 93-344, sec. 201(g), codified at 2 USC 601(f).

<sup>328</sup> See e.g., Joint Committee on Taxation, *Estimates of Federal Tax Expenditures* (JCS-2-08), October 31, 2008.

<sup>329</sup> See e.g., Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 110-667, December 2008.

<sup>330</sup> See e.g., Government Accountability Office, *Home Mortgage Interest Deduction* (GAO-09-769), July 29, 2009, and Government Accountability Office, *Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined* (GAO-05-690), September 23, 2005.



report on each tax expenditure extended by this Act. Reports for each tax expenditure enacted in subtitle C of title II (relating to business tax relief) and subtitle A of title II (relating to energy provisions) are to be submitted first, in order from those with the least aggregate cost to the greatest aggregate cost, determined by reference to the cost estimate of this Act by the Joint Committee on Taxation. Thereafter, reports may be submitted in such order as the Chief of Staff determines appropriate. Reports are due not later than November 30, 2010.

Such reports shall contain the following: (1) an explanation of the tax expenditure and any relevant economic, social, or other context under which it was first enacted; (2) a description of the intended purpose of the tax expenditure; (3) an analysis of the overall success of the tax expenditure in achieving such purpose, and evidence supporting such analysis; (4) an analysis of the extent to which further extending the tax expenditure, or making it permanent, would contribute to achieving such purpose; (5) a description of the direct and indirect beneficiaries of the tax expenditure, including identifying any unintended beneficiaries; (6) an analysis of whether the tax expenditure is the most cost-effective method for achieving the purpose for which it was intended, and a description of any more cost-effective methods through which such purpose could be accomplished; (7) a description of any unintended effects of the tax expenditure that are useful in understanding the tax expenditure's overall value; (8) an analysis of how the tax expenditure could be modified to better achieve its original purpose; (9) a brief description of any interactions (actual or potential) with other tax expenditures or direct spending programs in the same or related budget function worthy of further study; and (10) a description of any unavailable information the staff of the Joint Committee on Taxation may need to complete a more thorough examination and analysis of the tax expenditure, and what must be done to make such information available.

In the event the Chief of Staff of the Joint Committee on Taxation concludes it will not be feasible to complete all reports by November 30, 2010, at a minimum, the reports for each tax expenditure enacted in subtitle C of title II (relating to business tax relief) and subtitle A of title II (relating to energy provisions) shall be completed by such date.

#### **Effective Date**

The provision is effective on the date of enactment of this Act.

## **D. Temporary Disaster Relief Provisions**

### **1. Special rules for mortgage revenue bonds in Federally declared disaster areas (sec. 281 of the bill and sec. 143 of the Code)**

#### **Present Law**

##### **Qualified mortgage bonds**

###### **Generally**

Under present law, gross income does not include interest on State or local bonds.<sup>331</sup> 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).

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, qualified home improvement, or rehabilitation of owner-occupied residences.

The Code imposes several limitations on qualified mortgage bonds in the case of a purchase of a residence, including purchase price limitations for the residence 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)). The income limitation 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)).

Qualified home improvement loans are defined as financing, not in excess of \$15,000, of alterations, repairs, and improvements on or in connection with an existing residence by an owner thereof. These are further limited only to such items as substantially protect or improve the basic livability or energy efficiency of the property.

Rehabilitation loans are eligible for such financing if: (1) the mortgagor receiving the financing is the first resident after the completion of the rehabilitation; (2) at least 20 years have elapsed between the first use of the residence and the start of the physical work of the rehabilitation; (3) certain percentages of internal and external walls are retained after the

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<sup>331</sup> Sec. 103

rehabilitation; and (4) rehabilitation expenditures equal at least 25 percent of the taxpayer's adjusted basis in the residence after such rehabilitation (sec. 143(k)(5)).

#### 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)).

#### Special rules for Federally declared disaster areas

A temporary provision waives the first-time homebuyer requirement for residences located in Federally declared disaster areas (sec. 143(k)(11)). Also, under the provision, residences located in Federally declared disaster areas are treated as targeted area residences for purposes of the income and purchase price limitations. The special rules for residences located in Federally declared disaster areas applies to bonds issued after May 1, 2008, and before January 1, 2010.

### **Election to waive certain mortgage revenue bond rules**

#### In general

Present law allows certain taxpayers affected by natural disasters to elect to waive the first-time homebuyer requirement and modify the purchase price limitation from 90 percent to 110 percent, if the taxpayer's principal residence is destroyed as a result of a Federally declared disaster. Any owner-financing provided with respect to repair or reconstruction is deemed a qualified rehabilitation loan, if the taxpayer's principal residence is damaged as a result of a Federally declared disaster. If a taxpayer makes such an election, then the otherwise applicable special rules for Federally declared disaster areas do not apply. If there is no such election, then the otherwise applicable special rules for Federally declared disaster areas apply.

### Principal residence destroyed

This election for destroyed residences is available for principal residences located in Federally declared disaster areas when the principal residence of a taxpayer is: (1) rendered unsafe for use by reason of a Federally declared disaster occurring before January 1, 2010; or (2) demolished or relocated by reason of an order of the government of a State or political subdivision thereof on account of a Federally declared disaster occurring before January 1, 2010. This election applies for the two-year period beginning on the date of the disaster.

The election provides for: (1) a waiver of the first-time homebuyer requirement; and (2) the purchase price limitation otherwise applicable to targeted area residences (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).

### Principal residence damaged

The election for damaged residences allows certain taxpayers to elect to waive the otherwise applicable qualified rehabilitation loan rules and treat the cost of repair or reconstruction of a taxpayer's principal residence as a qualified rehabilitation loan. This election is limited to taxpayers whose principal residence is damaged as a result of a Federally declared disaster occurring before January 1, 2010. Such rehabilitation loans are limited to the lesser of \$150,000 or the cost of repair or reconstruction.

### Other rules

Once made, an election under these provisions may not be revoked by the taxpayer except with the consent of the Secretary.

For purposes of the provision, the term "Federally declared disaster" has the same definition as in section 165(h)(3)(C)(i) of the Code.<sup>332</sup> The provision is effective for disaster occurring after December 31, 2007. However, the provision does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.<sup>333</sup>

### **Explanation of Provision**

The provision extends for one additional year (through 2010): (1) the special rules for Federally declared disaster areas (sec. 143(k)(11)); and (2) the election to waive certain mortgage revenue bond rules relating to Federally declared disasters (sec. 143(k)(13)).

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<sup>332</sup> Sec. 165 relates to personal casualty losses.

<sup>333</sup> Sec. 712 of Pub. L. No. 110-343 Div. C.

## **Effective Date**

The provision relating to the special rules for Federally declared disaster areas is effective for bonds issued after December 31, 2009. The provision relating to the election to waive certain mortgage revenue bond rules relating to Federally declared disasters is effective for disasters occurring after December 31, 2009.

## **2. Deductibility of personal casualty losses attributable to Federally declared disasters (sec. 282 of the Act and sec. 165 of the Code)**

### **Present Law**

#### **Personal casualty losses**

##### **In general**

A taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.<sup>334</sup> For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of losses of property arising from fire, storm, shipwreck, or other casualty, or from theft.<sup>335</sup> In the case of any loss occurring in a disaster area and attributable to a Federally declared disaster area, the taxpayer may elect to take into account the casualty loss for the taxable year immediately preceding the taxable year in which the disaster occurs.<sup>336</sup>

##### **Dollar limitation**

In the case of an individual, a casualty or theft loss not connected with a trade or business or transaction entered into for profit (“personal casualty loss”) is allowed only to the extent the loss exceeds \$500 (\$100 for taxable years beginning after December 31, 2009).<sup>337</sup>

##### **Adjusted gross income limitation**

In general, the net aggregate personal casualty losses for a taxable year are deductible only to the extent they exceed 10 percent of an individual taxpayer’s adjusted gross income.<sup>338</sup>

Present law waives the 10-percent of adjusted gross income limitation for a “net disaster loss.” The term “net disaster loss” means the excess of personal casualty losses attributable to a

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<sup>334</sup> Sec. 165(a).

<sup>335</sup> Sec. 165(c).

<sup>336</sup> Sec. 165(i).

<sup>337</sup> Sec. 165(h)(1).

<sup>338</sup> Sec. 165(h)(2).

Federally declared disaster occurring before January 1, 2010, and occurring in a disaster area, over personal casualty gains. The term “Federally declared disaster” means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The term “disaster area” means the area so determined to warrant assistance.

### **Standard deduction**

An individual taxpayer’s taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer’s itemized deductions.<sup>339</sup> Unless an individual elects, no itemized deductions are allowed for the taxable year. The deduction for personal casualty losses is an itemized deduction.

Present law increases an individual taxpayer’s standard deduction by the “disaster loss deduction.” The “disaster loss deduction” means the net disaster loss (as defined above).

### **Explanation of Provision**

#### **One-year extension of net disaster loss**

The provision extends for one year the definition of a net disaster loss to include personal casualty losses attributable to Federally declared disasters occurring in 2010. Thus the waiver of the 10-percent of adjusted gross income limitation for net disaster losses and the inclusion of net disaster losses in the standard deduction are extended for one year.

#### **One-year extension of the increase to \$500 limitation per casualty**

The provision extends the \$500 per casualty dollar limitation for one year to taxable years beginning after December 31, 2009, and before January 1, 2011.

### **Effective Dates**

The provision generally applies to disasters occurring after December 31, 2009.

The provision increasing the limitation per casualty to \$500 applies to taxable years beginning after December 31, 2009.

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<sup>339</sup> Sec. 63.

### **3. Special depreciation allowance and expensing for qualified disaster assistance property (sec. 283 of the bill and secs. 168(n) and 179(e) of the Code)**

#### **Present Law**

##### **Special depreciation allowance**

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system (“MACRS”).<sup>340</sup> Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Present law includes an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of any “qualified disaster assistance property.”<sup>341</sup> The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, 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.

Qualified disaster assistance property means any property—(1) to which the general rules of the MACRS apply with (a) an applicable recovery period of 20 years or less, (b) computer software other than computer software covered by section 197, (c) water utility property (as defined in section 168(e)(5)), (d) certain leasehold improvement property, or (e) certain nonresidential real property and residential rental property; (2) substantially all of which is used in a disaster area with respect to a Federally declared disaster occurring before January 1, 2010, in the active conduct of a trade or business by the taxpayer in such disaster area; (3) which rehabilitates property damaged, or replaces property destroyed or condemned, as a result of the Federally declared disaster, except that property is treated as replacing property destroyed or condemned if, as part of an integrated plan, the property replaces property which is included in a continuous area which includes real property destroyed or condemned, and is similar in nature to, and located in the same county as, the property being rehabilitated or replaced; (4) the original use of the property in the disaster area commences with an eligible taxpayer (a taxpayer who has suffered an economic loss attributable to a Federally declared disaster) on or after the applicable

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<sup>340</sup> Sec. 168.

<sup>341</sup> Sec. 168(n).

disaster date (the date on which a Federally declared disaster occurs); (5) which is acquired by an eligible taxpayer by purchase (as defined under section 179(d)) by the taxpayer on or after the applicable disaster date (and no written binding contract for the acquisition was in effect before such date); and (6) which is placed in service by an eligible taxpayer on or before the date which is the last day of the third calendar year following the applicable disaster date (the fourth calendar year in the case of nonresidential real property and residential rental property).<sup>342</sup>

Qualified disaster assistance property does not include any property: (1) to which the special allowance for depreciation under section 168(k) (regardless of any election under section 168(k)(4)), section 168(l) for cellulosic biofuel property, or section 168(m) for reuse and recycling property applies; (2) to which the special allowance for qualified Gulf Opportunity Zone property under section 1400N(d) applies; (3) used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property (as defined in section 1400N(p)(3)(B)); (4) to which the alternative depreciation system under section 168(g) applies (determined without regard to the election to use such system under section 168(g)(7)); (5) any portion of which is financed with proceeds of any obligation the interest on which is exempt from tax under section 103; and (6) which is a qualified revitalization building with respect to which the taxpayer has made an election under section 1400I(a) to either expense one-half of qualified revitalization expenditures or recover such expenditures over 120 months.<sup>343</sup> A taxpayer may elect to not apply the rules of this provision with respect to any class of property for any taxable year.

The special rules of section 168(k)(2)(E) apply with modifications. For example, property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after the applicable disaster date, and which is placed in service by an eligible taxpayer on or before the date which is the last day of the third calendar year following the applicable disaster date (the fourth calendar year in the case of nonresidential real property and residential rental property). 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.

Recapture rules similar to section 179(d)(10) apply to any qualified disaster assistance property that ceases to be qualified disaster assistance property.

### **Section 179 expensing**

A taxpayer that satisfies limitations on annual investment may elect under section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through

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<sup>342</sup> Sec. 168(n)(2)(A).

<sup>343</sup> Sec. 168(n)(2)(B).



depreciation deductions.<sup>344</sup> For taxable years beginning in 2009, the maximum amount that a taxpayer may expense is \$250,000 of the cost of qualifying property placed in service for the taxable year. The \$250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000.<sup>345</sup> For taxable years beginning in 2010, the maximum amount that 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.

Qualified disaster assistance property is eligible for increased dollar limits on expensing under section 179. Specifically, the maximum amount that a taxpayer may expense is increased by the lesser of \$100,000 or the cost of qualified section 179 disaster assistance property placed in service in the taxable year. The \$800,000 limitation (for taxable years beginning in 2009) is increased by the lesser of \$600,000 or the cost of qualified section 179 disaster assistance property placed in service during the taxable year.<sup>346</sup>

Qualified section 179 disaster assistance property is 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) that meets the definition of qualified disaster assistance property.<sup>347</sup> Thus, the provision applies with respect to property placed in service in a disaster area with respect to a Federally declared disaster occurring before January 1, 2010.

### **Explanation of Provision**

The provision extends for one year the special depreciation allowance and expensing provisions for qualified disaster assistance property to apply to property placed in service in a disaster area with respect to a Federally declared disaster occurring before January 1, 2011.

### **Effective Date**

The provision is effective for disasters occurring after December 31, 2009.

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<sup>344</sup> Additional section 179 incentives are 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)).

<sup>345</sup> The temporary \$250,000 and \$800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, and extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

<sup>346</sup> Sec. 179(e)(1).

<sup>347</sup> Sec. 179(e)(2).

#### **4. Net operating losses attributable to Federally declared disasters (sec. 284 of the bill and sec. 172 of the Code)**

##### **Present Law**

A net operating loss (“NOL”) is, generally, the amount by which a taxpayer’s business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.<sup>348</sup> NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.<sup>349</sup>

Section 172(b)(1)(J) provides a special five-year carryback period for NOLs to the extent of a qualified disaster loss. A qualified disaster loss is the lesser of: (1) the sum of (a) section 165 losses for the taxable year attributable to a Federally declared disaster<sup>350</sup> occurring after December 31, 2007, and before January 1, 2010, and occurring in a disaster area,<sup>351</sup> and (b) the deduction for the taxable year for qualified disaster expenses allowable under section 198A(a) or which would be allowable as a deduction under that section if not treated as an expense in another section of the Code; or (2) the NOL for the taxable year.

A qualified disaster loss does not include any loss with respect to any property used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property (as defined in section 1400N(p)(3)(B)).

The amount of the NOL to which the five-year carryback period applies is limited to the amount of the corporation’s overall NOL for the taxable year. Any remaining portion of the taxpayer’s NOL is subject to the general two-year carryback period. Ordering rules similar to those for specified liability losses apply to losses carried back under section 172(b)(1)(J).

Any taxpayer entitled to the five-year carryback under section 172(b)(1)(J) may elect to have the carryback period determined without regard to this provision. In addition, the general rule which limits a taxpayer’s NOL deduction to 90 percent of alternative minimum taxable income (“AMTI”) does not apply to any NOL to which the five-year carryback period applies under the provision. Instead, a taxpayer may apply such NOL carrybacks to offset up to 100 percent of AMTI.

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<sup>348</sup> Sec. 172(b)(1)(A).

<sup>349</sup> Sec. 172(b)(2).

<sup>350</sup> The term “Federally declared disaster” means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

<sup>351</sup> The term “disaster area” means the area so determined to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Section 172(b)(1)(J) does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

### **Explanation of Provision**

The provision extends the five-year NOL carryback period for one year to apply to losses incurred in connection with Federally declared disasters occurring before January 1, 2011.

### **Effective Date**

The provision is effective for losses attributable to disasters occurring after December 31, 2009.

## **5. Expensing of qualified disaster expenses (sec. 285 of the bill and sec. 198A of the Code)**

### **Present Law**

A taxpayer may elect to treat any qualified disaster expense that is paid or incurred by the taxpayer as a deduction for the taxable year in which paid or incurred. For purposes of the provision, a qualified disaster expense is any otherwise capitalizable expenditure paid or incurred in connection with a trade or business or with business-related property that is: (1) for the abatement or control of hazardous substances that were released on account of a Federally declared disaster<sup>352</sup> occurring before January 1, 2010; (2) for the removal of debris from, or the demolition of structures on, real property damaged or destroyed as a result of a Federally declared disaster occurring before January 1, 2010; or (3) for the repair of business-related property damaged as a result of a Federally declared disaster occurring before January 1, 2010. No inference is intended as to the proper present law treatment of expenditures to repair business-related property damaged in a casualty event. The purpose of the provision is to provide that, in any case in which such costs are otherwise required to be capitalized, the costs may be deducted in the taxable year paid or incurred to the extent incurred as a result of a Federally declared disaster.

For purposes of section 198A, “business-related property” is property held by the taxpayer for use in a trade or business, for the production of income, or as inventory. In addition, any deduction allowed under this provision is treated as a deduction for depreciation and section 1245 property for purposes of applying the depreciation recapture rules.

This provision does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford

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<sup>352</sup> For these purposes, the term “Federally declared disaster” means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

### **Explanation of Provision**

The provision extends the deduction for qualified disaster expenditures for one year to apply to amounts paid or incurred in connection with Federally declared disasters occurring before January 1, 2011.

### **Effective Date**

The provision is effective for expenditures on account of disasters occurring after December 31, 2009.

## **6. Special depreciation allowance for certain New York Liberty Zone property (sec. 291 of the bill and sec. 1400L(b) of the Code)**

### **Present Law**

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system (“MACRS”).<sup>353</sup> Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Present law includes an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified New York Liberty Zone (“Liberty Zone”) property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, 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. A taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.

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<sup>353</sup> Sec. 168.

For property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be eligible real property.<sup>354</sup> Second, substantially all of the use of such property must be in the Liberty Zone. Third, the original use<sup>355</sup> of the property in the Liberty Zone must commence with the taxpayer on or after September 11, 2001.<sup>356</sup> Finally, the property must be acquired by purchase<sup>357</sup> by the taxpayer on or after September 11, 2001.

Nonresidential real property and residential rental property are eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed property, if as part of an integrated plan, such property replaces real property that is included in a continuous area that includes real property destroyed or condemned. It is intended that, for this purpose, real property destroyed (or condemned) only include circumstances in which an entire building or structure was destroyed (or condemned) as a result of the terrorist attacks. Otherwise, such property is considered damaged real property. For example, if certain structural components (e.g., wall, floors, or plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks, but the building is not destroyed (or condemned), then only costs related to replacing the damaged or destroyed components qualify for the provision.

Eligible real property that is constructed by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the construction of the property after September 11, 2001, and the property is placed in service on or before December 31, 2009 (assuming all other requirements are met). Property that is constructed for the taxpayer by another person under a contract that is entered into prior to the construction of the property is considered to be constructed by the taxpayer.<sup>358</sup>

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<sup>354</sup> For property acquired and placed in service prior to December 31, 2006, Liberty Zone property included property to which the general rules of MACRS apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), or (3) computer software other than computer software covered by section 197. A special rule precluded the additional first-year depreciation under section 1400L(b) for qualified New York Liberty Zone leasehold improvement property and for property eligible for the additional first-year depreciation under section 168(k) (i.e., property is eligible for only one 30 percent additional first year depreciation).

<sup>355</sup> Thus, used property may constitute qualified property so long as it has not previously been used within the Liberty Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Liberty Zone began with the taxpayer would satisfy the “original use” requirement. See Treas. Reg. Sec. 1.48-2, Example 5.

<sup>356</sup> 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.

<sup>357</sup> For this purpose, purchase is defined under section 179(d).

<sup>358</sup> Similar rules applied with respect to the manufacture or production of tangible personal property for which the manufacture or production began after September 11, 2001, and that was placed in service on or before December 31, 2006.

The Liberty Zone means 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.

#### **Explanation of Provision**

The provision extends for one year the additional 30-percent depreciation deduction for eligible real property to apply to property placed in service on or before December 31, 2010.

#### **Effective Date**

The provision is effective for eligible real property placed in service after December 31, 2009.

### **7. New York Liberty Zone bond provision (sec. 292 of the bill and sec. 1400L of the Code)**

#### **Present Law**

An aggregate of \$8 billion in tax-exempt private activity bonds is authorized for the purpose of financing the construction and repair of infrastructure in New York City ("Liberty Zone bonds"). The bonds must be issued before January 1, 2010.

#### **Explanation of Provision**

The provision extends authority to issue Liberty Zone bonds for one year (through December 31, 2010).

#### **Effective Date**

The provision is effective for bonds issued after December 31, 2009.

### **8. Increased rehabilitation credit for structures in the Gulf Opportunity Zone (sec. 295 of the bill and sec. 1400N(h) of the Code)**

#### **Present Law**

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, 2010. The provision is effective for expenditures incurred on or after August 28, 2005, for taxable years ending on or after August 28, 2005.

### **Explanation of Provision**

The provision extends for one additional year the increase in the rehabilitation credit from 20 to 26 percent, and from 10 to 13 percent, respectively, with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone. Thus, the increase applies for qualified rehabilitation expenditures with respect to such buildings or structures incurred before January 1, 2011.

### **Effective Date**

The provision is effective for amounts paid or incurred after December 31, 2009.

## **9. Work opportunity tax credit for Hurricane Katrina employees (sec. 296 of the bill)**

### **Present Law**

#### **General work opportunity tax credit rules**

##### **Targeted groups eligible for the credit**

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups.

##### **Qualified wages**

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

##### **Calculation of the credit**

Generally, the credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-

year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). In the case of certain qualified veterans, the definition of first-year wages is increased from \$6,000 to \$12,000, which increases the maximum credit per such employee to \$4,800. Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of \$10,000 for qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$9,000 (40 percent of the first \$10,000 of qualified first-year wages plus 50 percent of the first \$10,000 of qualified second-year wages).

#### Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

#### Certification requirement

In general, an individual is not treated as a member of a targeted group unless (1) on or before the day on which such individual begins work for the employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group or (2) on or before the day the individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual and not later than the twenty-first day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under the penalties of perjury, to the designated local agency as part of a written request for such a certification from such agency.

#### Qualifying rehires

No credit is available for any individual if, prior to the hiring date of such individual, such individual had been employed by the employer at any time.

#### Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit



generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

#### Expiration date

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before September 1, 2011.

### **Hurricane Katrina work opportunity tax credit rules**

#### In general

A Hurricane Katrina employee is treated as a member of a targeted group for purposes of the work opportunity tax credit. A Hurricane Katrina employee is: (1) an individual who on August 28, 2005, had a principal place of abode in the core disaster area and is hired during the four-year period beginning on such date for a position, the principal place of employment of which is located in the core disaster area.

#### Certification requirement

The WOTC certification requirement is waived for such individuals. In lieu of the certification requirement, an individual may provide to the employer reasonable evidence that the individual is a Hurricane Katrina employee.

#### Qualifying rehires

The general rule that denies the credit with respect to wages of employees who had been previously employed by the employer is waived for the first hire of such employee as a Hurricane Katrina employee unless such employee was an employee of the employer on August 28, 2005.

### **Explanation of Provision**

The provision extends the work opportunity tax credit for Hurricane Katrina employees for one year (through August 27, 2010).

#### **Effective Date**

The provision is effective for individuals hired after August 27, 2009.

### **10. Extend the placed-in service deadline for GO Zone low income housing credits for two years (sec. 297 and sec. 1400N(c)(5) of the Code)**

#### **Present Law**

#### **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.<sup>359</sup> These 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 January 1, 2011.

### **Explanation of Provision**

The provision extends the placed-in-service deadline (for two years) to January 1, 2013.

### **Effective Date**

The provision is effective on the date of enactment.

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<sup>359</sup> Rev. Proc. 2009-50.

## **TITLE III -- PENSION RELIEF**

### **A. Extended Period for Single-Employer Defined Benefit Plans to Amortize Certain Shortfall Amortization Bases (sec. 301 of the bill and secs. 430 and 4980F of the Code)**

#### **Present Law**

##### **Minimum funding rules**

###### **In general**

Defined benefit pension plans generally are subject to minimum funding rules that require the sponsoring employer to periodically make contributions to fund plan benefits.<sup>360</sup> The minimum funding rules for single-employer defined benefit pension plans were substantially revised by the Pension Protection Act of 2006 (“PPA”).<sup>361</sup> The PPA also revised the funding rules that apply to multiemployer defined benefit pension plans. The Worker, Retiree, and Employer Recovery Act of 2008 (“WRERA”)<sup>362</sup> made a number of technical corrections to the PPA. In addition, WRERA made certain amendments to the PPA minimum funding rules to provide funding relief to defined benefit plans affected by the decline in global financial markets during 2008.

The minimum funding rules for single-employer and multiemployer plans are different. A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement. There are also multiple employer plans, which are plans maintained by more than one employer and to which more than one employer is required to contribute, but that are not maintained pursuant to a collective bargaining agreement. The single-employer plan funding rules generally apply to multiple employer plans.

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<sup>360</sup> Sec. 412. Similar rules apply to defined benefit pension plans under the Labor Code provisions of the Employee Retirement Income Security Act of 1974 (“ERISA”). A number of exceptions to the minimum funding rules apply. For example, governmental and church plans are not subject to the minimum funding rules. Under section 414(d), a governmental plan is generally a plan established and maintained for its employees by the Federal government, a State government or political subdivision, or an agency or instrumentality of the foregoing. A governmental plan also includes 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 that is exempt from taxation by reason of the International Organizations Immunities Act. A governmental plan includes a plan 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, so long as all participants are employees of such entity, substantially all of whose services as employees are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function). Under section 414(e), a church plan is a plan established and maintained for its employees by a church or by a convention or association of churches which is exempt from tax under section 501. A church plan may elect to be subject to the minimum funding rules.

<sup>361</sup> Pub. L. No. 109-280.

<sup>362</sup> Pub. L. No. 110-458.

The purpose of the minimum funding rules is to ensure that the sponsoring employer of a defined benefit pension plan makes periodic minimum contributions that will adequately fund benefits promised under the plan. The rules permit an employer to fund the plan over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan.

The due date for the payment of a minimum required contribution for a plan year is generally eight and one-half months after the end of the plan year.<sup>363</sup> If unpaid minimum funding contributions for a single-employer plan exceed \$1,000,000, a lien arises in favor of the plan upon all property and rights to property (real or personal) belonging to the sponsoring employer (or member of the sponsoring employer's controlled group) in an amount equal to the unpaid minimum contributions.<sup>364</sup> Notice must be given to the Pension Benefit Guaranty Corporation ("PBGC")<sup>365</sup> of a funding failure that gives rise to a lien, and generally the lien is enforceable by the PBGC.

In the event of a failure to comply with the minimum funding rules, the Code imposes a two-level excise tax on the plan sponsor.<sup>366</sup> The initial tax is 10 percent of aggregate unpaid contributions for single-employer plans and five percent of the plan's accumulated funding deficiency (as defined below) for multiemployer plans. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the Internal Revenue Service ("IRS") or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the unpaid contribution or the accumulated funding deficiency, whichever is applicable. Before issuing a notice of deficiency with respect to the excise tax, the Secretary must notify the Secretary of Labor and provide the Secretary of Labor with a reasonable opportunity to require the employer responsible for contributing to, or under, the plan to correct the deficiency or comment on the imposition of the tax.

#### Funding target and shortfall amortization charges

The minimum required contribution for a plan year for single-employer defined benefit plans generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost.<sup>367</sup> The plan's funding target for a plan year is the present value of

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<sup>363</sup> Sec. 430(j).

<sup>364</sup> Sec. 430(k).

<sup>365</sup> The PBGC was established for the purpose of ensuring that benefits promised under a defined benefit pension plan are paid (up to specified annual limits) if the sponsoring employer is not able to fulfill its obligation to adequately fund the plan and the plan is terminated when it is underfunded. ERISA sec. 4002(a). The benefit protection function of the PBGC is carried out through an insurance program that applies to defined benefit pension plans. Sponsors of plans that are subject to the insurance program are liable to the PBGC for premium payments. PBGC termination insurance serves as a backstop to the minimum funding rules.

<sup>366</sup> Sec. 4971.

<sup>367</sup> Sec. 430.

all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits accrued or earned or expected to accrue or to be earned during the plan year. WRERA clarified that a plan's target normal cost is increased by the amount of plan-related expenses expected to be paid from plan assets during the plan year, and is decreased by the amount of mandatory employee contributions expected to be made to the plan during the plan year.<sup>368</sup>

A shortfall amortization base is determined for a plan year based on the plan's funding shortfall for the plan year.<sup>369</sup> In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets. The shortfall amortization base for a plan year is: (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases for preceding plan years. As a result, in any given plan year, a plan may have a number of shortfall amortization installments that relate to the current or prior years. The aggregate of these installments is referred to as the shortfall amortization charge. In the case of a plan with a funding shortfall for a plan year, the minimum required contribution is generally equal to the sum of the plan's target normal cost and the shortfall amortization charge for that year.

A shortfall amortization base may be positive or negative, depending on whether the present value of remaining installments with respect to prior year amortization bases is more or less than the plan's funding shortfall. In either case, the shortfall amortization base is amortized over a seven-year period beginning with the current plan year. Shortfall amortization installments for a particular plan year with respect to positive and negative shortfall amortization bases are netted in determining the shortfall amortization charge for the plan year, but the

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<sup>368</sup> This clarification is effective for plan years beginning after December 31, 2008, and is elective for the preceding plan year. Final regulations issued under section 430 reserve the issue of the definition of "plan-related expenses". The definition of the term is expected to be the subject of future proposed regulations. Treas. Reg. sec. 1.430(d)-1(b)(2)(iii)(B).

<sup>369</sup> Under a special rule, a shortfall amortization base does not have to be established for a plan year if the value of a plan's assets is at least equal to the plan's funding target for the plan year. For purposes of the special rule, a transition rule applies for plan years beginning after 2007 and before 2011. The transition rule does not apply to a plan that (1) was not in effect for 2007, or (2) was subject to certain deficit reduction contribution rules for 2007 (i.e., a plan covering more than 100 participants and with a funded current liability below a specified threshold). Under the transition rule, a shortfall amortization base does not have to be established for a plan year during the transition period if the value of plan assets for the plan year is at least equal to the applicable percentage of the plan's funding target for the year. The applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010. While the PPA provided that the transition rule did not apply to a plan for any plan year after 2008 unless, for each preceding plan year after 2007, the plan's shortfall amortization base was zero (i.e., the plan was eligible for the special rule each preceding year), WRERA amended the PPA rules to extend the transition rule to plan years beginning after 2008 even if, for each preceding plan year after 2007, the plan's shortfall amortization base was not zero. In addition, WRERA provided that, under the transition rules, only the applicable percentage of the funding target is taken into account in determining a plan's funding shortfall for the year, rather than the entire funding target.

resulting shortfall amortization charge cannot be less than zero (i.e., negative amortization installments may not offset normal cost).

If the value of the plan's assets exceeds the plan's funding target for a plan year, then the minimum required contribution is generally equal to the plan's target normal cost for the year. Target normal cost for this purpose is reduced (but not below zero) by the amount by which the value of the plan's assets exceed the plan's funding target.

#### Actuarial assumptions

The minimum funding rules for single-employer defined benefit pension plans specify the interest rates and other actuarial assumptions that must be used in determining a plan's target normal cost and funding target. Under the rules, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable at the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The corporate bond yield curve used for this purpose reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.

The present value of liabilities under a plan is determined using the segment rates for the "applicable month" for the plan year. The applicable month is the month that includes the plan's valuation date for the plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date. An election of a preceding month applies to the plan year for which it is made and all succeeding plan years unless revoked with the consent of the Secretary.

In lieu of the segment rates described above, a plan sponsor may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (i.e., without regard to the 24-month averaging described above) ("spot" rates). In general, such an election may be revoked only with approval of the Secretary. However, Treasury regulations provide automatic approval for plan sponsors to make a new choice of interest rates for 2009 and 2010 (regardless of what choices were made for earlier years).<sup>370</sup> In addition, for 2009, the IRS has indicated that it will

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<sup>370</sup> Treas. Reg. sec. 1.430(h)(2)-1(h)(3). Final regulations under sections 430(d), 430(f), 430(g), 430(h)(2), 430(i) and 436 were issued on October 7, 2009 and published in the Federal Register on October 15, 2009. 74 F.R. 53004 (October 15, 2009). The regulations are effective for plan years beginning on or after January 1, 2010, except for plans to which a delayed effective date applies. For plan years beginning before January 1, 2010, plans are permitted to rely on the final regulations or the proposed regulations (72 F.R. 74215) for purposes of satisfying the requirements of sections 430 and 436.

allow plan sponsors to use the spot rate for the month that includes the plan's valuation date for the 2009 plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date (rather than only for the month preceding the valuation date).<sup>371</sup>

### Notice requirements

#### Annual funding notice

The Employee Retirement Income Security Act of 1974 ("ERISA") requires defined benefit pension plans to provide participants with certain information related to funding and the funded status of the plan.<sup>372</sup> Under ERISA, the plan administrator of a single-employer defined benefit pension plan must provide an annual funding notice to: (1) each participant and beneficiary; (2) each labor organization representing such participants or beneficiaries; and (3) the PBGC.<sup>373</sup> Such a notice must include: (1) identifying information, including the name of the plan, the address and phone number of the plan administrator and the plan's principal administrative officer, the plan sponsor's employer identification number, and the plan identification number; (2) a statement as to whether the plan's funding target attainment percentage (as defined under the minimum funding rules for single-employer plans) for the plan year to which the notice relates and the two preceding plan years, is at least 100 percent (and, if not, the actual percentages); (3) a statement of (a) the plan's total assets (separately stating any funding standard carryover or prefunding balance) and liabilities for the plan year and the two preceding years, determined in the same manner as under the minimum funding rules, and (b) the value of the plan's assets and liabilities as of the last day of the plan year to which the notice relates, determined using fair market value and the interest rate used in determining variable rate premiums payable to the PBGC; (4) a statement of the number of participants who are retired or separated from service and receiving benefits, retired or separated participants who are entitled to future benefits, and active participants; (5) a statement setting forth the funding policy of the plan and the asset allocation of investments under the plan (expressed as percentages of total assets); (6) an explanation containing specific information of any plan amendment, scheduled benefit increase or reduction, or other known event taking effect in the current plan year and having a material effect on plan liabilities or assets for the year (as defined in regulations by the Secretary); (7) a summary of the rules governing the termination of a single-employer plan; (8) a general description of the benefits under the plan that are eligible to be guaranteed by the PBGC and the limitations of the guarantee and circumstances in which such limitations apply; (9) a statement that a person may obtain a copy of the plan's annual report upon request, through the Department of Labor Internet website, or through an Intranet website maintained by the applicable plan sponsor; (10) if applicable, a statement that each contributing sponsor, and each member of the sponsor's controlled group, is required to provide the information under section 4010 of ERISA for the plan year to which the notice relates; and (11) any additional information

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<sup>371</sup> Internal Revenue Service, Employee Plans News, March 2009 Special Edition.

<sup>372</sup> ERISA sec. 101(f).

the plan administrator elects to include to the extent it is not inconsistent with regulations prescribed by the Secretary of Labor.

In general, the annual funding notice must be provided within 120 days after the end of the plan year to which it relates.<sup>374</sup> The funding notice must be provided in a form and manner prescribed in regulations by the Secretary of Labor. Additionally, it must be written so as to be understood by the average plan participant and may be provided in written, electronic, or some other appropriate form to the extent that it is reasonably accessible to persons to whom the notice is required to be provided.

A plan administrator that fails to provide the required notice to a participant or beneficiary may be liable to the participant or beneficiary in the amount of up to \$100 a day from the time of the failure and for such other relief as a court may deem proper.

#### Notice of significant reduction in benefit accruals

If an amendment to a defined benefit pension plan provides for a significant reduction in the rate of future benefit accrual, the plan administrator must furnish a written notice concerning the amendment.<sup>375</sup> Notice may also be required if a plan amendment eliminates or reduces an early retirement benefit or retirement-type subsidy. The plan administrator is required to provide the notice to any participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment (and to any employee organization representing affected participants). The notice must be written in a manner calculated to be understood by the average plan participant and must provide sufficient information to allow recipients to understand the effect of the amendment. The plan administrator is generally required to provide the notice at least 45 days before the effective date of the plan amendment.

An excise tax of \$100 a day from the time of the failure is imposed on an employer who fails to provide the required notice to a participant or alternate payee. For purposes of calculating the excise tax, each failure to provide an individual participant or alternate payee is treated as a separate failure. If the employer exercises reasonable diligence to meet the notice requirements, the amount of the penalty for a taxable year is capped at \$500,000 for failures during the taxable year of the employer.

The excise tax does not apply where the employer exercises reasonable diligence to satisfy the notice requirements and the notice is provided during the thirty-day period beginning on the first date the employer knew, or exercising reasonable diligence would have known, that

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<sup>373</sup> Plan sponsors of multiemployer plans are required to provide a similar notice to the same parties, as well as to each employer that has an obligation to contribute under the plan.

<sup>374</sup> In the case of a plan covering not more than 100 employees for the preceding year, the annual funding notice must be provided upon filing of the annual report with respect to the plan (i.e., within seven months after the end of the plan year unless the due date for the annual report is extended).

<sup>375</sup> Sec. 4980F(e)(1); ERISA sec. 204(h)(1).



the failure existed. In addition, the employer will not be subject to the excise tax if the Secretary determines that the employer did not know the failure existed and exercised reasonable diligence to meet the notice requirements. The Secretary is authorized to waive part or all of the tax if the failure is due to reasonable cause and not to willful neglect and the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

ERISA provides that, where the failure to provide a notice of a significant reduction in benefit accruals is egregious, the provisions of the plan are applied as if the amendment entitles all affected participants and alternate payees to the greater of (1) the benefits to which they would have been entitled without regard to the amendment or (2) the benefits under the plan with regard to the amendment.

### **Explanation of Provision**

#### **Election of extended amortization schedule**

The provision permits the plan sponsor of certain single-employer defined benefit pension plans to elect to determine the shortfall amortization installments with respect to the shortfall amortization base for not more than two applicable plan years under two alternative extended amortization schedules. In general, an applicable plan year is a plan year beginning in 2008, 2009, 2010, or 2011; however, a plan sponsor may elect the plan year beginning in 2008 as an applicable plan year only if the due date for the payment of the minimum required contribution for that plan year occurs on or after March 10, 2010.

While a plan sponsor's ability to elect an extended amortization schedule is limited to two applicable plan years, the two applicable plan years need not be consecutive and the plan sponsor is not required to elect the same extended amortization schedule in each of the two applicable plan years. For example, a plan sponsor that is eligible to elect an extended amortization schedule could elect the fifteen-year amortization schedule (as defined below) for the plan year beginning in 2009 and could make a subsequent election to use either the fifteen-year amortization schedule or the two plus seven amortization schedule (as defined below) for the plan year beginning in 2011.

A plan sponsor is not eligible to elect an extended amortization schedule with respect to a plan if, as of the date of the election: (1) the plan sponsor is a debtor in a case under title 11, United States Code, or similar Federal or State law; (2) there are unpaid minimum required contributions with respect to the plan for purposes of section 4971 (imposing an excise tax when minimum required contributions are not paid by the due date for the plan year); (3) a lien in favor of the plan has arisen under section 430(k) because unpaid minimum required contributions exceed \$1,000,000; and (4) the plan sponsor has initiated a distress termination of the plan under ERISA section 4041.

An election to use an extended amortization schedule is irrevocable, except under such limited circumstances, and subject to such conditions, as the Secretary of the Treasury may prescribe.

### Two plus seven amortization schedule

Under the provision, the sponsor of a single-employer defined benefit plan may elect to amortize the shortfall amortization base for an applicable plan year over a nine-year period beginning with the applicable plan year (“two plus seven amortization schedule”). The shortfall amortization installments for the first two plan years in the nine-year period are equal to the interest on the shortfall amortization base for the applicable plan year, determined by using the effective interest rate for the applicable plan year.<sup>376</sup> The shortfall amortization installments for the last seven plan years in the nine-year period are equal to the amounts necessary to amortize the balance of that shortfall amortization base in level annual installments over the remainder of the seven-year period, determined by using the segment rates for the applicable plan year.

### Fifteen-year amortization schedule

Alternatively, the sponsors of certain single-employer defined benefit plans may elect to amortize the shortfall amortization base for an applicable plan year over a fifteen-year period beginning with the applicable plan year (“fifteen-year amortization schedule”).

### **Increase in required installments for certain plans**

#### In general

Under the provision, any plan year in a restriction period (and any plan year outside the restriction period to which an “installment acceleration amount” (as defined below) may be carried over under the rules described below) is a year in which the shortfall amortization installment otherwise determined and payable for that year pursuant to an election to use an extended amortization schedule may be increased, subject to certain limits described below, by an “installment acceleration amount.” The length of the restriction period following an election to use an extended amortization schedule for an applicable plan year depends on the extended amortization schedule elected by the plan sponsor for that applicable plan year. For a plan sponsor who elects to use the two plus seven amortization schedule for an applicable plan year, the restriction period is the three-year period beginning with either the applicable plan year or, if later, the first plan year beginning after December 31, 2009. For a plan sponsor who elects to use the fifteen-year amortization schedule for an applicable plan year, the restriction period is the five-year period beginning with either the applicable plan year or, if later, the first plan year beginning after December 31, 2009.

For example, for a plan sponsor who elects to use the two plus seven amortization schedule for the plan year beginning in 2009, the restriction period with respect to that election is the three-year period during the 2010, 2011 and 2012 plan years. If the same plan sponsor then elects to use the two plus seven amortization schedule for the plan year beginning in 2011, the

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<sup>376</sup> The effective interest rate with respect to a plan for a plan year is the single rate of interest which, if used to determine the present value of the benefits taken into account in determining the plan’s funding target for the year, would result in an amount equal to the plan’s funding target (as determined using the first, second, and third segment rates). Sec. 430(h)(2)(A).

separate restriction period with respect to that election is the three-year period during the 2011, 2012 and 2013 plan years.

For purposes of the rules governing installment acceleration amounts, “plan sponsor” includes any member of the plan sponsor’s controlled group (as determined for purposes of the minimum funding rules).

#### Installment acceleration amount

The “installment acceleration amount” with respect to any plan year in a restriction period with respect to an applicable plan year is the sum of: (1) the aggregate amount of excess employee compensation for the plan year and (2) the dividend and redemption amount for the plan year.

#### Excess employee compensation

Excess employee compensation is compensation (as defined below) with respect to any employee (including a self-employed individual treated as an employee under section 401(c)) for any plan year in excess of \$1,000,000. Beginning in 2011, the \$1,000,000 threshold is indexed to the Consumer Price Index for Urban Consumers, rounded, if the amount of any increase is not a multiple of \$20,000, to the next lowest multiple of \$20,000.

For purposes of determining excess employee compensation, “compensation” includes all amounts attributable to services performed by an employee for a plan sponsor after December 31, 2009 that are includable in the employee’s income as remuneration during the calendar year in which the plan year begins, regardless of whether the services were performed during such calendar year. In the case of a self-employed individual treated as an employee under section 401(c), compensation includes the earned income (within the meaning of section 401(c)(2)) of such individual. Compensation does not include any remuneration consisting of nonqualified deferred compensation, restricted stock, restricted stock units, stock options, or stock appreciation rights payable or granted under a binding written contract in effect on March 1, 2010 and not modified in any material respect before the remuneration is paid. Compensation does not include any remuneration payable to an employee on a commission basis solely on account of income directly generated by that employee’s individual performance. This exception does not apply to remuneration payable on a commission basis to an employee who is a specified employee as defined in section 409A<sup>377</sup> or an employee who would be a specified employee if the plan sponsor was a corporation described in that section.

Excess employee compensation for any employee during a calendar year also includes any amount (regardless of whether such amount exceeds \$1,000,000) that the plan sponsor directly or indirectly sets aside or reserves in, or transfers to, a trust (or other arrangement

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<sup>377</sup> Under section 409A(a)(2)(B)(i), a specified employee is a key employee (as defined in section 416(i)) of a corporation any stock in which is publicly traded on an established securities market or otherwise. For purposes of section 409A, the rule in section 416(i) under which the term “key employee” includes the beneficiaries of an employee is disregarded.

specified by the Secretary) during the calendar year for purposes of paying deferred compensation to the employee under a nonqualified deferred compensation plan (as defined in section 409A) of the plan sponsor.

Under the provision, no amount is taken into account more than once in calculating excess employee compensation. For example, if an amount set aside in a trust during the calendar year for purposes of paying deferred compensation to an employee under a nonqualified deferred compensation plan is otherwise includable in income as remuneration by the employee in that calendar year, it is only taken into account once in calculating excess employee compensation for that employee for the calendar year.

#### Dividend and redemption amount

The dividend and redemption amount for a plan year is the lesser of: (1) the excess of the sum of the dividends paid during the plan year by the plan sponsor, plus the amounts paid for the redemption of stock of the plan sponsor redeemed during the plan year, over an amount equal to the average of the plan sponsor's adjusted annual net income for the plan sponsor's last five fiscal years ending before such plan year; or (2) the sum of the amounts paid for the redemption of stock of the plan sponsor redeemed during the plan year, plus the excess of the dividends paid during the plan year by the plan sponsor over the "dividend base amount."

For purposes of the provision, the plan sponsor's adjusted annual net income for any fiscal year is determined in accordance with generally accepted accounting principles (before after-tax gain or loss on any sale of assets), but without regard for any reduction by reason of depreciation or amortization. In no event shall a plan sponsor's adjusted annual net income for any fiscal year be less than zero.

The "dividend base amount" is, with respect to a plan year, an amount equal to the greater of: (1) the median of the amounts of dividends paid during each of the plan sponsor's last five fiscal years ending before such plan year or (2) the amount of dividends during such plan year on preferred stock that was issued on or before May 21, 2010, or that is replacement stock for such preferred stock.

Certain dividends and redemptions are disregarded in calculating the dividend and redemption amount for a plan year. As an initial matter, for purposes of the provision, except with respect to the calculation of the dividend base amount, only dividends declared and redemptions occurring after February 28, 2010 are taken into account. In addition, dividends paid by one member of the plan sponsor's controlled group to another member of the controlled group are disregarded in calculating the dividend and redemption amount for a plan year. In the case of redemptions of securities that are not, at the time of redemption, listed on an established securities market, the following amounts are disregarded: (1) redemptions made pursuant to a pension plan that is qualified under section 401 or a shareholder-approved program; or (2) redemptions made on account of an employee's termination of employment with the plan sponsor or the death or disability of a shareholder. Redemptions of securities that are not, immediately after issuance, listed on an established securities market, and that are, or had previously been: (1) held directly or indirectly by, or for the benefit of, the Federal government or a Federal reserve bank; or (2) held by a national government (or a government-related entity

of such a government) or an employee benefit plan if such securities are substantially identical to securities described in (1), are also disregarded.

#### Limitation on installment acceleration amounts

Under the provision, the installment acceleration amount for a plan year is limited to the cumulative amount of funding relief received by the plan sponsor as a result of an election to use an extended amortization schedule for an applicable plan year. To the extent that an installment acceleration amount is limited by application of this rule, the excess installment acceleration amount is generally carried over to the succeeding plan year.

Thus, under the provision, the installment acceleration amount for any plan year may not exceed the excess (if any) of: (1) the sum of the shortfall amortization installments for that plan year and all prior plan years in the nine- or fifteen-year amortization period, as elected, with respect to the shortfall amortization base for the applicable plan year, that would have been determined and payable by the plan sponsor with respect to that shortfall amortization base in the absence of an election to use an extended amortization schedule; over (2) the sum of the shortfall amortization installments for such plan years, determined under the two and seven or fifteen-year amortization schedule, as elected, including any installment acceleration amount carried over from a preceding plan year (“annual limit”).

To the extent that a carryover of excess installment acceleration amounts from a preceding plan year, when added to other installment acceleration amounts for a plan year (as determined prior to application of the annual limit on installment acceleration amounts) would cause the shortfall amortization installment for the plan year to exceed the annual limit, the excess is similarly carried over to the next succeeding plan year. Under the provision, the following ordering rule applies in applying the annual limit for a plan year: the installment acceleration amounts for the plan year, determined prior to the addition of any carryover installment acceleration amount from a preceding year, is applied first against the annual limit and then any carryover installment acceleration amounts are applied against the annual limit on a first-in, first-out basis.

The carryover rules apply during the restriction period with respect to an applicable plan year and, in the case of an election to use a fifteen-year amortization schedule, for a limited number of years following the expiration of the restriction period with respect to an applicable plan year. Under the provision, no amount is carried over to a plan year that begins after the last plan year in the restriction period applicable to a two plus seven amortization schedule and no amount is carried over to a plan year that begins after the second plan year following the last plan year in the restriction period applicable to a fifteen-year amortization schedule.

#### Adjustment to amortization schedule to reflect installment acceleration amounts

An additional rule (subject to rules prescribed by the Secretary) applies under the provision to insure that the addition of an installment acceleration amount to a shortfall amortization installment for a plan year results only in an acceleration of the payment of amounts that would otherwise be included in subsequent shortfall amortization installments with respect

to the shortfall amortization base for the applicable plan year and not in the amortization of an amount in excess of that shortfall amortization base.

Therefore, if the shortfall amortization installment with respect to the shortfall amortization base for an applicable plan year is required to be increased by any installment acceleration amount, the remaining shortfall amortization installments with respect to that shortfall amortization base are reduced, in reverse order of the otherwise required installments beginning with the final scheduled installment, to the extent necessary to limit the present value of the remaining installments to the present value of the remaining unamortized shortfall amortization base.

Under the provision, any installment acceleration amount is disregarded for purposes of determining a plan's quarterly contributions.

### **Notice requirements**

#### **Initial notice requirement**

The provision amends section 4980F to require that, not later than 30 days following an election to use an extended amortization schedule, the plan administrator provide notice of the election to each plan participant and beneficiary, each labor organization representing such participants and beneficiaries, and the PBGC. As under present law governing failures to provide notice of a significant reduction in the rate of future benefit accruals, an excise tax of \$100 a day from the time of the failure to provide the required initial notice is imposed on an employer who fails to provide the required notice to a participant or alternate payee.

The notice is required to contain a statement that recently enacted legislation permits employers to delay pension funding. The notice must also contain the amount of contributions that would have been required in the absence of the election; the amount of the reduction in minimum required contributions for the applicable plan year that occurs as a result of the election; the number of plan years to which that reduction will apply; an explanation of the installment acceleration amount rules (as described above); and a statement that increases in required contributions may occur in the event of future excess employee compensation or certain dividend or share repurchasing activity and that subsequent notices of any such payments or activity will be provided in the plan's annual funding notice. The notice must also provide, with respect to a plan's funding status as of the end of the plan year preceding the applicable plan year, the plan's benefit liabilities (determined using the assumptions used by the PBGC in determining liabilities) and the market value of the plan's assets. The notice is required to be written in a manner calculated to be understood by the average plan participant. The Secretary is required to prescribe a model notice that a plan administrator may use to satisfy the initial notice requirements.

The provision adds a similar requirement to section 204 of ERISA. As under current ERISA section 204(h) (relating to the provision of notice of significant reduction in benefit accruals), a plan sponsor's egregious failure to meet any of the initial notice requirements results in the election to use an extended amortization schedule as being treated as not having been made. An egregious failure occurs when the failure is in the control of the plan sponsor and is

(1) intentional (including any failure to promptly provide the required notice or information after the plan administrator discovers an unintentional failure to meet the notice requirements); (2) a failure to provide most of the participants and beneficiaries with most of the information they are entitled to receive; or (3) determined to be egregious under regulations prescribed by the Secretary.

#### Subsequent supplemental notices

The provision requires a plan administrator to disclose, as part of the annual funding notice required under ERISA, any excess employee compensation and any dividend and redemption amount determined for the preceding plan year.

#### Use of new technologies

The provision permits the Secretary, in consultation with the Secretary of Labor, by regulations or other guidance of general applicability, to allow a plan administrator to provide any initial or subsequent supplemental notice using new technologies.

#### **Regulations and guidance**

The Secretary is directed to provide rules for the application of the provisions governing installment acceleration amounts to plan sponsors who elect an extended amortization schedule for two or more plans, including rules for the ratable allocation of any installment acceleration amount among electing plans on the basis of each plan's relative reduction in its shortfall amortization installment for the first plan year in the extended amortization period. The Secretary is also directed to provide transition rules for the application of those provisions and the provisions governing the election of an extended amortization schedule in any case where there is a merger or acquisition involving an electing plan sponsor.

The Secretary may also prescribe such regulations and other guidance of general applicability as the Secretary determines is necessary to achieve the purposes of the rules governing the election of an extended amortization schedule or schedules and the acceleration of contributions on account of excess employee compensation and dividend and redemption amounts.

#### **Effective Date**

The provision is effective for plan years beginning after December 31, 2007.

## **B. Application of Extended Amortization Period to Plans Subject to Prior Law Funding (sec. 302 of the bill and sec. 412 of the Code)**

### **Present Law**

#### **In general**

Defined benefit pension plans generally are subject to minimum funding requirements under ERISA and the Code.<sup>378</sup> PPA made significant changes to the minimum funding requirements for single-employer plans. Generally, those modifications became effective for plan years beginning after December 31, 2007. As discussed below, however, there are delayed effective dates for certain plans including multiple employer plans of certain cooperatives, certain PBGC settlement plans, and plans of certain government contractors.

#### **Multiple employer plans of certain cooperatives**

Section 104 of PPA provides a delayed effective date for the PPA's single-employer plan funding rules for any plan that was in existence on July 26, 2005, and was an eligible cooperative plan for the plan year including that date. A plan is treated as an eligible cooperative plan for a plan year if it is maintained by more than one employer and at least 85 percent of such employers are: (1) certain rural cooperatives;<sup>379</sup> or (2) certain cooperative organizations that are more than 50-percent owned by agricultural producers or by cooperatives owned by agricultural producers, or organizations that are more than 50-percent owned, or controlled by, one or more such cooperative organizations. A plan is also treated as an eligible cooperative plan for any plan year for which it is maintained by more than one employer and is maintained by a rural telephone cooperative association.

The PPA's funding rules do not apply with respect to an eligible cooperative plan for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan; or (2) January 1, 2017. In addition, in applying the pre-PPA funding rules to an eligible cooperative plan for plan years beginning after December 31, 2007, and before the first plan year for which the PPA funding rules apply, the interest rate used is the interest rate applicable under the PPA funding rules with respect to payments expected to be

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<sup>378</sup> Sec. 412 and sec. 302 of ERISA. Multiemployer defined benefit pension plans are also subject to the minimum funding requirements, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans. Governmental plans and church plans are generally exempt from the minimum funding requirements.

<sup>379</sup> This is as defined in Code section 401(k)(7)(B) without regard to (iv) thereof and includes (1) organizations engaged primarily in providing electric service on a mutual or cooperative basis, or engaged primarily in providing electric service to the public in its service area and which is exempt from tax or which is a State or local government, other than a municipality; (2) certain civic leagues and business leagues exempt from tax 80 percent of the members of which are described in (1); (3) certain cooperative telephone companies; and (4) any organization that is a national association of organizations described above.



made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the PPA funding rules).<sup>380</sup>

#### Certain PBGC settlement plans

The PPA provides a delayed effective date for its single-employer plan funding rules for any plan that was in existence on July 26, 2005, and was a “PBGC settlement plan” as of that date. The term “PBGC settlement plan” means a single-employer defined benefit plan: (1) that was sponsored by an employer in bankruptcy proceedings giving rise to a claim by the PBGC of not greater than \$150 million, and the sponsorship of which was assumed by another employer (not a member of the same controlled group as the bankrupt sponsor) and the PBGC’s claim was settled or withdrawn in connection with the assumption of the sponsorship; or (2) that, by agreement with the PBGC, was spun off from a plan subsequently terminated by the PBGC in an involuntary termination.

The PPA’s funding rules do not apply with respect to a PBGC settlement plan for plan years beginning before January 1, 2014. In addition, in applying the pre-PPA funding rules to such a plan for plan years beginning after December 31, 2007, and before January 1, 2014, the interest rate used is the third segment rate under the PPA funding rules.

#### Plans of certain government contractors

The PPA provides a delayed effective date for its single-employer plan funding rules for any eligible government contractor plan. A plan is treated as an eligible government contractor plan if it is maintained by a corporation (or member of the same affiliated group): (1) whose primary source of revenue is derived from business performed under contracts with the United States that are subject to the Federal Acquisition Regulations<sup>381</sup> and also to the Defense Federal Acquisition Regulation Supplement;<sup>382</sup> (2) whose revenue derived from such business in the previous fiscal year exceeded \$5 billion; and (3) whose pension plan costs that are assignable under those contracts are subject to certain provisions of the Cost Accounting Standards.<sup>383</sup>

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<sup>380</sup> PPA specifies the interest rates that must be used in determining a plan’s target normal cost and funding target. Present value is determined using three interest rates (“segment” rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period.

<sup>381</sup> Chapter 1 of Title 48, C.F.R..

<sup>382</sup> Chapter 2 of Title 48, C.F.R..

<sup>383</sup> 48 C.F.R. 9904.412 and 9904.413.

The PPA funding rules do not apply with respect to such a plan for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan; (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule;<sup>384</sup> and (3) the first plan year beginning after December 31, 2010. In addition, in applying the pre-PPA funding rules to such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the PPA funding rules apply, the interest rate used is the third segment rate under the PPA funding rules.

### **General minimum funding rules for plans with delayed PPA effective dates**

#### **Funding standard account**

As an administrative aid in the application of the pre-PPA funding requirements, a defined benefit pension plan is required to maintain a special account called a “funding standard account” to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan. Other charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments, experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

In determining plan funding under an actuarial cost method, a plan’s actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If the plan’s actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized as credits or charges to the funding standard account over five years.

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the plan’s accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. The gain or loss for a year from changes in actuarial assumptions is amortized as credits or charges to the funding standard account over ten years.

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<sup>384</sup> Section 106(d) of PPA requires the Cost Accounting Standards Board to review and revise sections 412 and 413 of the Cost Accounting Standards (48 C.F.R. 9904.412 and 9904.413) to harmonize the minimum required contributions under ERISA of eligible government contractor plans and government reimbursable pension plan costs, not later than Jan. 1, 2010. Any final rule adopted by the Cost Accounting Standards Board will be considered the Cost Accounting Standards Pension Harmonization Rule.

If minimum required contributions are waived, the waived amount (referred to as a “waived funding deficiency”) is credited to the funding standard account. The waived funding deficiency is then amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded.

If, as of the close of a plan year, the funding standard account reflects credits at least equal to charges, the plan is generally treated as meeting the minimum funding standard for the year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an “accumulated funding deficiency.” Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the funding standard account would exceed credits to the account if no contribution were made to the plan. For example, if the balance of charges to the funding standard account of a plan for a year would be \$200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

#### Funding methods and general concepts

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

The plan’s normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan: (1) in level dollar amounts; (2) as a uniform percentage of payroll; (3) as a uniform amount per unit of service (e.g., \$1 per hour); or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. For example, the cost attributable to a past service liability is generally amortized over 30 years.

Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually and is made as of a date within the plan year or within one month before the beginning of the plan year. However, a valuation date within the preceding plan year may be used if, as of that date, the value of the plan's assets is at least 100 percent of the plan's current liability (i.e., the present value of benefits under the plan, as described below).

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined on the basis of a reasonable actuarial valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period not to exceed the five most recent plan years, including the current year.

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be determined if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.<sup>385</sup>

### **Additional contributions for underfunded plans with delayed PPA effective dates**

#### **In general**

Under special funding rules (referred to as the "deficit reduction contribution" rules),<sup>386</sup> an additional charge to a plan's funding standard account is generally required for a plan year if the plan's funded current liability percentage for the plan year is less than 90 percent.<sup>387</sup> A plan's "funded current liability percentage" is generally the actuarial value of plan assets as a percentage of the plan's current liability.<sup>388</sup> In general, a plan's current liability means all

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<sup>385</sup> Under present law, certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary.

<sup>386</sup> The deficit reduction contribution rules apply to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under these rules.

<sup>387</sup> Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if (1) the plan's funded current liability percentage for the plan year is at least 80 percent, and (2) the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

liabilities to employees and their beneficiaries under the plan, determined on a present-value basis.

The amount of the additional charge required under the deficit reduction contribution rules is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution (as described below), over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits. The amount of the additional charge cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent (taking into account the expected increase in current liability due to benefits accruing during the plan year).

The deficit reduction contribution is generally the sum of: (1) the "unfunded old liability amount," (2) the "unfunded new liability amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.<sup>389</sup> The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent. For example, if a plan's funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).<sup>390</sup>

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. The value of any unpredictable contingent event benefit is not considered in determining additional contributions until the event has occurred. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

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<sup>388</sup> In determining a plan's funded current liability percentage for a plan year, the value of the plan's assets is generally reduced by the amount of any credit balance under the plan's funding standard account. However, this reduction does not apply in determining the plan's funded current liability percentage for purposes of whether an additional charge is required under the deficit reduction contribution rules.

<sup>389</sup> The deficit reduction contribution may also include an additional amount as a result of the use of a new mortality table prescribed by the Secretary in determining current liability for plan years beginning after 2006.

<sup>390</sup> In making these computations, the value of the plan's assets is reduced by the amount of any credit balance under the plan's funding standard account.

### **Explanation of Provision**

The provision offers two types of funding relief to underfunded plans with delayed PPA effective dates.<sup>391</sup> Under the provision a plan sponsor may elect either: (1) reduced additional funding requirements; or (2) a 15-year amortization period for purposes of determining the plan's unfunded new liability amount. The number of applicable years for which a plan sponsor elects relief under the provision reduces the number of applicable years for which the plan sponsor may elect relief under section 301 of the bill.

Plan sponsors of eligible plans may elect relief for not more than two applicable years under the alternative additional funding provision or one applicable year under the amortization provision. Plan sponsors may not, however, elect both types of relief. Under the alternative additional funding provision, a plan sponsor may choose to elect relief for only one applicable plan year, or, if electing relief for two applicable plan years, may make such election for non-consecutive applicable plan years. For example, a plan sponsor that elects to use the alternative additional funding rule for the plan year beginning in 2009 can make an election to use that same rule for the plan year beginning in 2010 or 2011; however, the plan sponsor is not permitted to elect to use the 15-year amortization relief. Generally, relief may be elected for plan years beginning in 2009, 2010, or 2011. Plan sponsors are required to provide notice, similar to the notice required by section 4980F(f) (as added by section 301 of the bill), within 30 days of electing either type of relief under the provision.

A plan is eligible to elect relief only if, at the time of the election, the following conditions are met: (1) the plan sponsor is not a debtor in a case under title 11, United States Code, or similar Federal or State law; (2) there are no accumulated funding deficiencies with respect to the plan;<sup>392</sup> (3) there is no lien in favor of the plan due to the plan's failure to make required contributions;<sup>393</sup> and (4) the plan sponsor has not initiated a distress termination of the plan under ERISA section 4041.

The provision requires the Secretary to prescribe rules for making elections.

### **Alternative additional funding charge**

The provision permits plan sponsors of underfunded plans with delayed PPA effective dates to elect to use alternate rules for calculating the amount of additional charges required as a result of the plan's underfunded status. Under the provision's alternate rules, the plan's deficit

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<sup>391</sup> That is, multiple employer plans of certain cooperatives (as defined in section 104 of PPA), certain PBGC settlement plans (as defined in section 105 of PPA), and plans of certain government contractors (as defined in section 106 of PPA).

<sup>392</sup> An accumulated funding deficiency is, generally, the excess of the total charges to the funding standard account for all plan years (beginning with the first year for which section 412 applies to the plan) over the total credits to such account for such years, or, if less, the excess of the total charges to the alternative minimum funding standard account for such plan years over the total credits to such account for such years. See sec. 412(a).

<sup>393</sup> See sec. 412(n).

reduction contribution will be deemed to be zero for purposes of determining the additional charge to the plan's funding standard account required for the plan year. The amount of the additional charge, however, is increased by an amount equal to the installment acceleration amount with respect to the plan sponsor for such plan year. Generally, the "installment acceleration amount" is the sum of the aggregate amount of excess employee compensation for the plan year and the aggregate amount of certain dividends and redemptions for the plan year.<sup>394</sup> If a plan sponsor elects to use the provision's alternate rules for calculating the amount of additional charges for more than one plan, the installment acceleration amount is apportioned ratably between the plans in proportion to the deficit reduction contributions of the plans (determined without regard to the provision).

An electing plan's additional funding charge will not be higher than the amount of additional charges that would have been required as a result of the plan's underfunded status without regard to the plan's election of relief under the provision.

### **15-year amortization**

The provision permits plan sponsors of underfunded plans with delayed PPA effective dates to elect to use a special applicable percentage for purposes of calculating a portion of their unfunded new liability amount for any pre-effective date plan year beginning with or after the applicable plan year. The special applicable percentage is the ratio of: (1) the annual installments payable in each year if the increased unfunded new liability for that plan year was amortized in equal installments over 15 years, using an interest rate equal to the third segment rate under the PPA funding rules; to (2) the increased unfunded new liability for the plan year. This special applicable percentage applies with respect to the portion of the plan's unfunded new liability that is its increased unfunded new liability. For this purpose, the increased unfunded new liability is the excess, if any, of the new unfunded liability over the amount of new unfunded liability determined as if the plan's assets were equal to the product of the current liability and the plan's funded current liability percentage for the second plan year proceeding the first year of the election. The increased unfunded new liability is redetermined annually and the applicable percentage is redetermined based on the number of years remaining in the 15 year period. The electing plan continues to use the pre-PPA applicable percentage in calculating its unfunded new liability amount with respect to the excess of the unfunded new liability over the increased unfunded new liability.

The amount of the plan's funding liability, however, is increased by an amount equal to the installment acceleration amount<sup>395</sup> with respect to the plan sponsor for such plan year. An electing plan's funding liability will not be higher than it would have been had it not elected relief under the provision.

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<sup>394</sup> See explanation of installment acceleration amount in the explanation, above, of section 301 of the bill.

<sup>395</sup> As described above in the explanation of section 301 of the bill, except without regard to the cumulative limitations contained in sec. 430(c)(2)(F)(iii)(II).

### **Eligible charity plans**

The provision amends section 104 of PPA by making the section applicable to eligible charity plans, at the election of such plans. Under the provision, therefore, the delayed PPA effective date and special interest rates rules that apply to eligible cooperative plans may apply to eligible charity plans as well. A plan is an eligible charity plan for a plan year if: (1) employees of the employer (or employers) maintaining the plan are accruing benefits under the plan based on service for the plan year; (2) such employees are employed in at least 20 states; and (3) each such employee (other than a de minimis number) is employed by an employer that is a tax exempt organization under section 501(c)(3) whose primary exempt purposes is to provide services with respect to children. An election to become an eligible charity plan may be revoked only with the consent of the Secretary.

The Secretary is authorized to prescribe regulations as necessary to carry out the purpose of the provision. It is expected that the Secretary will have to issue guidance regarding, among other issues, how the pre-PPA rules apply to an eligible charity plan that has been subject to the PPA rules for prior years.

### **Effective Date**

In general, the provision is effective for plan years beginning on or after January 1, 2009. The provisions relating to eligible charity plans are effective for plan years beginning after December 31, 2009.



**C. Suspension of Certain Funding Limitations**  
**(sec. 303 of the bill and secs. 430 and 436 of the Code)**

**Present Law**

Defined benefit pension plans are subject to minimum funding requirements that require the sponsoring employer to periodically make contributions to fund plan benefits. For plans subject to the PPA, the minimum required contribution to a defined benefit plan (other than a multiemployer plan) for a plan year is determined under section 430. For these plans, the minimum required contribution depends on whether the plan has (1) a funding excess for the plan year (generally, where the value of plan assets exceeds the plan's "funding target" for the plan year), or (2) a funding shortfall (generally, where the value of plan assets is less than the funding target for the plan year).

Section 436 imposes certain benefit restrictions on single-employer defined benefit plans that apply if a plan's "adjusted funding target attainment percentage" for a plan year is less than a certain threshold. A plan's funding target attainment percentage is defined as the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to at-risk status). A plan's adjusted funding target attainment percentage is determined in the same way, except that the value of the plan's assets and the plan's funding target are both increased by the aggregate amount of purchases of annuities for employees other than highly compensated employees made by the plan during the two preceding plan years. Special rules apply for determining a plan's adjusted funding target attainment percentage in the case of a fully funded plan and for plan years beginning in or after 2007 and before 2011. In addition, certain presumptions apply in determining whether benefit restrictions apply with respect to a plan, subject to certification of the plan's adjusted funding target attainment percentage by the plan's enrolled actuary.<sup>396</sup>

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<sup>396</sup> If a plan was subject to a limitation for the preceding year, the plan's adjusted funding target attainment percentage for the current year is presumed to be the same as for the preceding year until the plan actuary certifies the plan's actual adjusted funding target attainment percentage for the current year. If (1) a plan was not subject to a limitation for the preceding year, but its adjusted funding target attainment percentage for the preceding year was not more than 10 percentage points greater than the threshold for a limitation, and (2) as of the first day of the fourth month of the current plan year, the plan actuary has not certified the plan's actual adjusted funding target attainment percentage for the current year, the plan's funding target attainment percentage is presumed to be reduced by ten percentage points as of that day, and that day is deemed to be the plan's valuation date for purposes of applying the benefit limitation. As a result, the limitation applies as of that date until the actuary certifies the plan's actual adjusted funding target attainment percentage. In any other case, if the plan actuary has not certified the plan's actual adjusted funding target attainment percentage by the first day of the tenth month of the current plan year, for purposes of the limitations, the plan's adjusted funding target attainment percentage is conclusively presumed to be less than 60 percent as of that day and that day is deemed to be the valuation date for purposes of applying the benefit limitations. For purposes of applying the presumptions to plan years beginning in 2008, the funding target attainment percentage for the preceding year was permitted to be determined using such methods of estimation as the Secretary may provide.

## **Cessation of benefit accruals**

### **General rule**

A plan must provide that, if the plan's adjusted funding target attainment percentage is less than 60 percent for a plan year, all future benefit accruals under the plan must cease as of the valuation date for the plan year.<sup>397</sup> This limitation applies only for purposes of the accrual of benefits; service during the freeze period is counted for other purposes (i.e., towards a plan's service requirement for vesting purposes).

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

### **Temporary lookback rule**

The Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA"),<sup>398</sup> amended the rules to provide that, in the case of the first plan year beginning during the period from October 1, 2008, through September 30, 2009, the cessation of future benefit accrual limitation of section 436 is applied by substituting the plan's adjusted funding target attainment percentage for the preceding plan year for the percentage for such first plan year in the period. Thus, the future benefit accrual limitation of section 436 is avoided if the plan's adjusted funding target attainment percentage for the preceding plan year is 60 percent or greater. If, however, the adjusted funding target attainment percentage for the current plan year is greater than the preceding year, the look back rule does not apply and the adjusted funding target attainment percentage for the current plan year is used in determining whether the limitation applies.

## **Unpredictable contingent event benefit**

If a participant is entitled to an unpredictable contingent event benefit payable with respect to any event occurring during any plan year, the plan must provide that such benefits may not be provided if the plan's adjusted funding target attainment percentage for that plan year: (1) is less than 60 percent; or (2) would be less than 60 percent taking into account the occurrence of the event.<sup>399</sup> For this purpose, the term unpredictable contingent event benefit means any benefit payable solely by reason of: (1) a plant shutdown (or similar event, as determined by the Secretary of the Treasury); or (2) any event other than attainment of any age, performance of any service, receipt or derivation of any compensation, or the occurrence of

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<sup>397</sup> Sec. 436(e).

<sup>398</sup> Pub. L. No. 110-458.

<sup>399</sup> Sec. 436(b)(1).

death or disability. The determination of whether this limitation applies is made in the year the unpredictable contingent event occurs, regardless of whether the benefits are paid in that year or a subsequent plan year. The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to: (1) if the plan's adjusted funding target attainment percentage is less than 60 percent, the amount of the increase in the plan's funding target for the plan year attributable to the occurrence of the event; or (2) if the plan's adjusted funding target attainment percentage would be less than 60 percent taking into account the occurrence of the event, the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.<sup>400</sup>

If, subject to the rules below, a funding-based limit on unpredictable contingent event benefits would apply to a plan for the plan year, then the plan sponsor is deemed to have made an election to reduce the prefunding balance or the funding standard carryover balance by the amount necessary for the benefit limit not to apply to the plan for the plan year.<sup>401</sup> For purposes of the rules governing deemed elections, the determination of whether a funding-based limit on unpredictable contingent event benefits would apply to a plan is made without regard to (1) any deemed elections, and (2) any contributions (in addition to any minimum required contribution for the plan year) made by the plan sufficient to cease application of the funding-based limit on unpredictable contingent event benefits.

### **Prohibited payments**

A plan must provide that, if the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, the plan will not make any "prohibited payments" after the valuation date for the plan year.<sup>402</sup> For purposes of these limitations, a prohibited payment is: (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period; (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract); (3) any transfer of assets and liabilities to another plan maintained by the same employer (or by any member of the employer's controlled group) that is made in order to avoid or terminate the application of the PPA benefit limitations; or (4) any other payment specified by the Secretary by regulations.

A plan must also provide that, if the plan's adjusted funding target attainment percentage for a plan year is 60 percent or greater, but less than 80 percent, the plan may not pay any prohibited payments exceeding the lesser of: (1) 50 percent of the amount otherwise payable

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<sup>400</sup> Sec. 436(b)(2).

<sup>401</sup> Sec. 426(f)(3)(A).

<sup>402</sup> Sec. 436(d).

under the plan; and (2) the present value of the maximum PBGC guarantee with respect to the participant (determined under guidance prescribed by the PBGC, using the interest rates and mortality table applicable in determining minimum lump-sum benefits). The plan must provide that only one payment under this exception may be made with respect to any participant<sup>403</sup> during any period of consecutive plan years to which the limitation applies.

In addition, a plan must provide that, during any period in which the plan sponsor is in bankruptcy proceedings, the plan may not make any prohibited payment. This limitation does not apply on or after the date the plan's enrolled actuary certifies that the adjusted funding target attainment percentage of the plan is not less than 100 percent.

With respect to the prohibited payment rule, certain frozen plans, meaning plans that do not provide for any future benefit accruals, are grandfathered. The prohibited payment limitation does not apply to a plan for any plan year if the terms of the plan (as in effect for the period beginning on September 1, 2005, and ending with the plan year) provide for no benefit accruals with respect to any participant during the period. In addition, in the case of a terminated plan, while any benefit restriction in effect immediately before the termination of the plan continues to apply, the limitation on prohibited payments does not apply to payments made to carry out the termination of the plan in accordance with applicable law.<sup>404</sup>

#### Definition of social security supplement

As noted above, payment of a social security supplement in combination with a single life annuity is not a prohibited payment. A social security supplement is an ancillary benefit that is permitted to be offered under a defined benefit plan. An ancillary benefit is a benefit provided under the plan that is not a retirement-type subsidy or an optional form of payment of a participant's accrued benefit and that is paid in addition to a participant's accrued benefit or any benefit treated as an accrued benefit. Specifically, a social security supplement is a benefit for plan participants that commences before the age and terminates before the age when participants are entitled to old-age insurance benefits, unreduced on account of age, under title II of the Social Security Act, and does not exceed such old-age insurance benefit.<sup>405</sup>

#### Treatment of payments under social security leveling option

A social security leveling option is an optional form of benefit with a social security leveling feature, which is a payment of a participant's accrued benefit commencing prior to a participant's expected commencement of social security benefits that provides for a temporary period of higher payments, which is designed to result in an approximately level amount of

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<sup>403</sup> For purposes of the prohibited payment rules, the benefits provided with respect to a participant and any beneficiary of the participant (including an alternate payee) are aggregated. If the participant's accrued benefit is allocated to an alternate payee and one or more other persons, the amount that may be distributed is allocated in the same manner unless the applicable qualified domestic relations order provides otherwise.

<sup>404</sup> Treas. Reg. sec. 1.436-1(a)(3)(ii).

<sup>405</sup> Treas. Reg. sec. 1.411(a)-7(c)(4).

income when the participant's estimated old age benefits from Social Security are taken into account.<sup>406</sup> Although a social security leveling option may provide a participant with the same stream of payments as a single life annuity plus a social security supplement, the amount in excess of a single life annuity under a social security leveling option paid before social security retirement age is a prohibited payment.

### **Explanation of Provision**

#### **Look-back rule governing the cessation of benefit accruals**

The provision extends WRERA's look-back rule governing the cessation of benefit accruals to any plan year beginning during the period beginning on October 1, 2008, and ending on December 31, 2011. However, rather than using the plan's adjusted funding target attainment percentage for the preceding plan year, the adjusted funding target attainment percentage for the last plan year ending before September 30, 2009, is used. The provision is not intended to place a plan in a worse position with respect to the future benefit accrual limitation of section 436 than would apply absent the provision. Thus, the provision does not apply if the adjusted funding target attainment percentage for the current plan year is greater than the adjusted funding target attainment percentage for the last plan year ending before September 30, 2009.

#### **Application of credit balances with respect to limitations on unpredictable contingent event benefits**

With respect to plan years beginning on or before December 31, 2011, the provision also changes the rules governing deemed elections by plans subject to funding based limitations on unpredictable contingent event benefits. Under the provision, with respect to such plan years, for purposes of the rules governing deemed elections, the determination of whether a funding-based limit on unpredictable contingent event benefits would apply to a plan takes into account contributions (in addition to any minimum required contribution for the plan year) made by the plan sufficient to cease application of the funding-based limit on unpredictable contingent event benefits. Thus, the requirement to reduce the prefunding balance or funding standard carryover balance in order to avoid the application of the funding-based limit on unpredictable contingent event benefit can be avoided by the contribution of an amount sufficient to avoid the application of that limit.

#### **Social Security level-income options**

For purposes of the prohibition against making certain prohibited payments when a plan's funding target attainment percentage is less than 60 percent (or 80 percent, as applicable), with respect to distributions with an annuity starting date occurring on or before December 31, 2011, the definition of prohibited payment is revised so that an optional form of benefit will not include a prohibited payment merely because it is a social security leveling option. Thus, under the provision, prohibited payments would also not include payments under a optional form of benefit identified under a plan as social security leveling option that provides exclusively for payments

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<sup>406</sup> Treas. Reg. sec. 1.411(d)-3(g)(16).

before the age when the participant becomes entitled to Social Security old-age insurance benefits, but as is required for an optional form of benefit to be a social security leveling option, the annual payment amount under the option does not exceed the participant's estimated annual Social Security old-age insurance benefit.

### **Effective Date**

The lookback rule governing the cessation of benefit accruals and the provision regarding the application of credit balances with respect to limitations on unpredictable contingent event benefits are effective on date of enactment.

The provision excepting social security level-income options from the definition of prohibited payments applies to any payments under an optional form of benefit with an annuity starting date occurring on or after January 1, 2011. However, a plan is not treated as failing to meet the requirements of section 436(d) merely because the plan sponsor elects to apply the provision to any such payments with an annuity starting date occurring on or after the provision's date of enactment and before January 1, 2011.

**D. Lookback for Credit Balance Rules**  
**(sec. 304 of the bill and sec. 430 of the Code)**

**Present Law**

**In general**

Under the PPA funding rules, credit balances that accumulated under pre-PPA law (“funding standard carryover balances”) are preserved and, for plan years beginning after 2007, new credit balances (referred to as “prefunding balances”) result if the plan sponsor of a single-employer defined benefit plan makes contributions greater than those required under the PPA funding rules. In general, plan sponsors may choose whether to count funding standard carryover balances and prefunding balances in determining the value of plan assets or to use the balances to reduce required contributions, but not both.

**Funding standard carryover balance**

The funding standard carryover balance consists of a beginning balance in the amount of the positive balance in the funding standard account as of the end of the 2007 plan year, decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For each plan year beginning after 2008, the funding standard carryover balance is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the funding standard carryover balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

**Prefunding balance**

The prefunding balance consists of a beginning balance of zero for the 2008 plan year, increased and decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years, i.e., as of the first day of plan year beginning after 2008 (the “current” plan year), the plan sponsor may increase the prefunding balance by an amount, not to exceed: (1) the excess (if any) of the aggregate total employer contributions for the preceding plan year, over (2) the minimum required contribution for the preceding plan year. For this purpose, any excess contribution for the preceding plan year is adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined using the effective interest rate of the plan for the preceding plan year and treating contributions as being first used to satisfy the minimum required contribution.

In determining the amount of the increase in a plan’s prefunding balance, the amount by which the aggregate total employer contributions for the preceding plan year exceeds the minimum required contribution for the preceding plan year is reduced (but not below zero) by the amount of contributions an employer would need to make to avoid a benefit limitation that

would otherwise be imposed for the preceding plan year under the rules relating to benefit limitations for single-employer plans (as discussed below).<sup>407</sup>

For each plan year beginning after 2008, the prefunding balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the prefunding balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

Application of balances to the value of plan assets or to reduce minimum required contributions

If a plan sponsor elects to maintain a funding standard carryover balance or prefunding balance, the amount of those balances is generally subtracted from the value of plan assets for purposes of determining a plan's minimum required contributions, including a plan's funding shortfall, and a plan's funding target attainment percentage (defined as the ratio, expressed as a percentage, that the value of the plan's assets bears to the plan's funding target for the year). The value of a plan's assets is not reduced by these balances if a binding written agreement with the PBGC providing that all or a portion of the plan's funding standard carryover balance or prefunding balance is not available to offset the minimum required contribution for a plan year is in effect. In addition, for purposes of determining whether a plan is required to establish a shortfall amortization base for a plan year, the funding standard carryover balance is not subtracted from the value of plan assets and the prefunding balance is required to be subtracted from the value of plan assets only if an election has been made to use the balance to offset the plan's minimum required contribution for the plan year. However, the plan sponsor may elect to permanently reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the minimum required contribution for the plan year.

If the value of the plan's assets (reduced by any prefunding balance but not by any funding standard carryover balance) is at least 80 percent of the plan's funding target for the preceding plan year, a plan sponsor is generally permitted to credit all or a portion of the funding standard carryover balance or prefunding balance against the minimum required contribution for the current plan year, thus reducing the amount that must be contributed for the current plan year.<sup>408</sup> If a plan sponsor has elected to permanently reduce a funding standard carryover balance or prefunding balance, any reduction of such balances applies before determining the amount that is available for crediting against minimum required contributions for the plan year.

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<sup>407</sup> Any contribution that may be taken into account in satisfying the requirement to make additional contributions with respect to more than one type of benefit limitation is taken into account only once for purposes of this reduction.

<sup>408</sup> In the case of plan years beginning in 2008, the percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.



### Other rules

In determining the prefunding balance or funding standard carryover balance as of the first day of a plan year, the plan sponsor must adjust the balance in accordance with regulations prescribed by the Secretary to reflect the rate of return on plan assets for the preceding year.<sup>409</sup> The rate of return is determined on the basis of the fair market value of the plan assets and must properly take into account, in accordance with regulations, all contributions, distributions, and other plan payments made during the period.

To the extent that a plan has a funding standard carryover balance of more than zero for a plan year, none of the plan's prefunding balance may be credited to reduce a minimum required contribution, nor may an election be made to reduce the prefunding balance for purposes of determining the value of plan assets. Thus, the funding standard carryover balance must be used for these purposes before the prefunding balance may be used.

Any election relating to the prefunding balance and funding standard carryover balance is to be made in such form and manner as the Secretary prescribes.<sup>410</sup>

### **Explanation of Provision**

Under the provision, for any plan year beginning after June 30, 2009, and on or before December 31, 2011, for purposes of determining whether a single-employer defined benefit plan is sufficiently funded so as to be permitted to credit all or a portion of its funding standard carryover balance or prefunding balance against the minimum required contribution for the plan year, the plan may use the greater of: (1) its funding target attainment percentage (determined without regard to the provision) for the prior plan year, or (2) the funding target attainment percentage for the plan year beginning after June 30, 2007 and on or before June 30, 2008, as determined under rules prescribed by the Secretary. Thus, the provision temporarily permits plans whose funded status for the lookback year was at least equal to 80 percent to offset their minimum required contributions by a credit balance, even if the plan would not otherwise be permitted to do so.

For plans with valuation dates other than the first day of the plan year, the provision applies for any plan year beginning after December 31, 2008, and on or before December 31, 2010, and any such plan may use the funding target attainment percentage for the last plan year beginning before July 1, 2007, as determined under rules prescribed by the Secretary.

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<sup>409</sup> Treas. Reg. sec. 1.430(f)-1(b)(3).

<sup>410</sup> See Treas. Reg. sec. 1.430(f)-1(f) for the rules governing elections relating to prefunding balances and funding standard carryover balances.

### **Effective Date**

The provision is generally effective for plan years beginning after June 30, 2009. For plans with valuation dates other than the first day of the plan year, the provision is effective for plan years beginning after December 31, 2008.

**E. Rollover of Amounts Received in Airline Carrier Bankruptcy**  
**(sec. 306 of the bill)**

**Present Law**

The Code provides for two types of individual retirement arrangements (“IRAs”): traditional IRAs and Roth IRAs.<sup>411</sup> In general, contributions (other than a rollover contribution) to a traditional IRA may be deductible, and distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions. In contrast, contributions to a Roth IRA are not deductible, and qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, 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 on or after the individual attains age 59½, death, or disability or which is a qualified special purpose distribution.

The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount (\$5,000 for 2010); or (2) the amount of the individual’s compensation that is includible in gross income for the year. As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount.

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 for the individual’s income tax return for that year.<sup>412</sup> 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.<sup>413</sup>

Taxpayers generally may convert a traditional IRA into a Roth IRA.<sup>414</sup> The amount converted is includible in income as if a withdrawal had been made,<sup>415</sup> except that the early

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<sup>411</sup> Traditional IRAs are described in section 408, and Roth IRAs are described in section 408A.

<sup>412</sup> Sec. 408A(d)(6).

<sup>413</sup> Treas. Reg. sec. 1.408A-6.

<sup>414</sup> 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.

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 certain requirements are satisfied, a participant in an employer-sponsored qualified plan (which includes a tax-qualified retirement plan described in section 401(a), an employee retirement annuity described in section 403(a), a tax-sheltered annuity described in section 403(b), and a governmental section 457(b) plan) or a traditional IRA may roll over distributions from the plan, annuity or IRA into another plan, annuity or IRA. For distributions after December 31, 2007, certain taxpayers also are permitted to make rollover contributions into a Roth IRA (subject to inclusion in gross income of any amount that would be includible were it not part of the rollover contribution).

Under section 125 of the Worker, Retiree, and Employer Recovery Act of 2008 (“WRERA”),<sup>416</sup> a “qualified airline employee” may contribute any portion of an “airline payment amount” to a Roth IRA within 180 days of receipt of such amount (or, if later, within 180 days of enactment of the provision). Such a contribution is treated as a qualified rollover contribution to the Roth IRA. Thus, the portion of the airline payment amount contributed to the Roth IRA is includible in gross income to the extent that such payment would be includible were it not part of the rollover contribution.

A qualified airline employee is an employee or former employee of a commercial passenger airline carrier who was a participant in a defined benefit plan maintained by the carrier which: (1) is qualified under section 401(a); and (2) was terminated or became subject to the benefit accrual and other restrictions applicable to plans maintained by commercial passenger airlines pursuant to section 402(b) of PPA.

An airline payment amount is any payment of any money or other property payable by a commercial passenger airline to a qualified airline employee: (1) under the approval of an order of a Federal bankruptcy court in a case filed after September 11, 2001, and before January 1, 2007; and (2) in respect of the qualified airline employee’s interest in a bankruptcy claim against the airline carrier, any note of the carrier (or amount paid in lieu of a note being issued), or any other fixed obligation of the carrier to pay a lump sum amount. An airline payment amount does not include any amount payable on the basis of the carrier’s future earnings or profits. The amount that may be contributed to a Roth IRA is the gross amount of the payment; any reduction in the airline payment amount on account of employment tax withholding is disregarded.

### **Explanation of Provision**

The provision expands the choices for recipients of airline payment amounts by allowing qualified airline employees to contribute airline payment amounts into a traditional IRA as a

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<sup>415</sup> 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.

<sup>416</sup> Pub. L. No. 110-455.

rollover contribution. An individual making such a rollover contribution may exclude the contributed airline payment amount from gross income in the taxable year in which the airline payment amount was paid.

Qualified airline employees who made a qualified rollover contribution of an airline payment amount to a Roth IRA pursuant to WRERA are also permitted to recharacterize all or a portion of the qualified rollover contribution as a rollover contribution to a traditional IRA by transferring, in a trustee- to-trustee transfer, the contribution (or a portion thereof) plus attributable earnings (or losses) from the Roth IRA to a traditional IRA. As in the case of a recharacterization under present law, the airline payment amount so transferred (with attributable earnings) is deemed to have been contributed to the traditional IRA at the time of the initial rollover contribution into the Roth IRA. The trustee-to-trustee transfer to a traditional IRA, to recharacterize an airline payment amount originally contributed to a Roth IRA as a rollover contribution, must be made within 180 days of enactment.

If an amount contributed to a Roth IRA as a rollover contribution is recharacterized as a rollover contribution to a traditional IRA, the amount so recharacterized may not be contributed to a Roth IRA as a qualified rollover contribution (i.e. reconverted to a Roth IRA) during the five taxable years immediately following the taxable year in which the transfer to the traditional IRA was made.

Qualified airline employees who were eligible to make a qualified rollover to a Roth IRA under WRERA, but declined to do so, are now permitted to rollover the airline payment amount to a traditional IRA within 180 days of the receipt of the amount (or, if later, within 180 days of enactment of the provision). As mentioned above, any portion of an airline payment amount recharacterized as a rollover contribution to a traditional IRA pursuant to the provision is excluded from gross income in the taxable year in which the airline payment amount was paid to the qualified airline employee by the commercial passenger airline carrier. Individuals recharacterizing such contributions may file a claim for a refund until the later of: (1) the period of limitations under section 6511(a) (generally, three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later); or (2) April 15, 2011.

An airline payment amount is treated as wages for purposes of Social Security and Medicare taxes under the Federal Insurance Contributions Act<sup>417</sup> and section 209 of the Social Security Act, regardless of whether the amount is excluded from gross income because it is rolled-over into a traditional IRA pursuant to the provision.

Surviving spouses of qualified airline employees are granted the same rights as qualified airline employees under section 125 of WRERA and under the provision.

### **Effective Date**

Effective for all transfers (made after date of enactment) of qualified airline payment amounts received before, on, or after date of enactment.

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<sup>417</sup> Chapter 21 of the Code.

**F. Optional Use of 30-Year Amortization Periods**  
**(sec. 311 of the bill and sec. 431 of the Code)**

**Present Law**

Defined benefit pension plans generally are subject to minimum funding rules under the Code that require the sponsoring employer to periodically make contributions to fund plan benefits. Similar rules apply to defined benefit pension plans under the Labor Code provisions of ERISA.

The minimum funding rules for single-employer and multiemployer plans are different.<sup>418</sup> A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement.<sup>419</sup>

**Funding standard account**

A multiemployer defined benefit pension plan is required to maintain a special account called a “funding standard account” to which charges and credits (such as credits for plan contributions) are made for each plan year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, the plan has an “accumulated funding deficiency” equal to the amount of such excess charges. For example, if the balance of charges to the funding standard account of a plan for a year would be \$200,000 without any contributions, then a minimum contribution equal to that amount is required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If credits to the funding standard account exceeds charges, a “credit balance” results. The amount of the credit balance, increased with interest, can be used to reduce future required contributions.

**Amortization periods**

A plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an acceptable actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as the normal cost, and the amortization of supplemental cost. The normal cost for a plan for a plan year generally represents the cost of future benefits allocated to the plan year under the funding method used by the plan for current employees. The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets, such as a net experience loss. Supplemental costs are amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. The amortization

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<sup>418</sup> The PPA modified the minimum funding rules for multiemployer defined benefit pension plans. These modifications are generally effective for plan years beginning after 2007

<sup>419</sup> Sec. 414(f).

period applicable to a multiemployer plan for most credits and charges is 15 years.<sup>420</sup> Past service liability under the plan is amortized over 15 years<sup>421</sup>; past service liability due to plan amendments is amortized over 15 years; and experience gains and losses resulting from a change in actuarial assumptions are amortized over 15 years. Experience gains and losses and waived funding deficiencies are also amortized over 15 years.

The Secretary, upon receipt of an application, is required to grant an extension of the amortization period for up to five years with respect to any unfunded past service liability, investment loss, or experience loss.<sup>422</sup> There must be included with the application a certification by the plan's actuary that: (1) absent the extension, the plan would have an accumulated funding deficiency in the current plan year and any of the nine succeeding plan years; (2) the plan sponsor has adopted a plan to improve the plan's funding status; (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures; and (4) required notice has been provided. The automatic extension provision does not apply with respect to any application submitted after December 31, 2014. The Secretary may also grant an additional extension of such amortization periods for up to an additional five years.<sup>423</sup>

### **Actuarial assumptions**

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which must be reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

### **Valuation of plan assets**

In determining the charges and credits to be made to the plan's funding standard account for a multiemployer plan, the value of plan assets may be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary.<sup>424</sup> Thus, the actuarial value of a plan's

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<sup>420</sup> Sec. 431(b)(2). Prior to the effective date of PPA, the amortization period was 30 years for past service liability, past service liability due to plan amendments, and losses and gains resulting from a change in actuarial assumptions.

<sup>421</sup> In the case of a plan in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 40 years. In the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 30 years. Past service liability due to plan amendments was amortized over 30 years.

<sup>422</sup> Sec. 431(d)(1).

<sup>423</sup> Sec. 431(d)(2).

<sup>424</sup> Sec. 431(c)(2).

assets under a reasonable actuarial valuation method can be used instead of fair market value. A reasonable actuarial valuation method generally can include a smoothing methodology that takes into account reasonable expected investment returns and average values of the plan assets, so long as the smoothing or averaging period does not exceed the five most recent plan years, including the current plan year. In addition, in order to be reasonable, any actuarial valuation method used by the plan is required to result in a value of plan assets that is not less than 80 percent of the current fair market value of the assets and not more than 120 percent of the current fair market value.<sup>425</sup> In determining plan funding under an acceptable actuarial cost method, a plan's actuary generally must make certain assumptions regarding the future experience of a plan.

The actuarial valuation method is considered to be part of the plan's funding method. The same method must be used for each plan year. If the valuation method is changed, the change is only permitted to take effect if approved by the Secretary.<sup>426</sup>

### **Additional funding rules for plans in endangered or critical status**

Under section 432,<sup>427</sup> additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of, and compliance with, the following: (1) a funding improvement plan in the case of a multiemployer plan in endangered status; and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional required contributions and benefit reductions apply and employers are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Section 432 is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015 must continue to operate under such plan until the funding improvement or rehabilitation period (as explained below) expires or the plan emerges from endangered or critical status.

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<sup>425</sup> Treas. Reg. sec. 1.412(c)(2)-1(b). Rev. Proc. 2000-40, 2000-2 CB 357, generally indicates that only an averaging period that does not exceed five years will be approved by the IRS. The revenue procedure also indicates that for a funding valuation method to be approved, the asset value determined under the method must be adjusted to be no greater than 120 percent and no less than 80 percent of the fair market value.

<sup>426</sup> Sec. 412(d)(1).

<sup>427</sup> Parallel rules apply under ERISA.



## **Failure to comply with minimum funding rules**

In the event of a failure to comply with the minimum funding rules, the Code imposes a two-level excise tax on the plan sponsor.<sup>428</sup> The initial tax is five percent of the plan's accumulated funding deficiency for multiemployer plans. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the IRS or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the unpaid contribution or the accumulated funding deficiency, whichever is applicable. Before issuing a notice of deficiency with respect to the excise tax, the Secretary must notify the Secretary of Labor and provide the Secretary of Labor with a reasonable opportunity to require the employer responsible for contributing to, or under, the plan to correct the deficiency or comment on the imposition of the tax.

### **Explanation of Provision**

#### **Optional use of 30 year amortization**

##### **Relief provisions**

Notwithstanding the otherwise applicable amortization periods under the funding rules for multiemployer plans, the provision allows the plan sponsor of a multiemployer plan that meets a solvency test to elect to use a relief provision in maintaining its funding standard account. Under the relief provision, the plan sponsor of a multiemployer plan may elect to treat the portion of any experience loss or gain for a plan year that is equal to the allocable portion of the net investment losses incurred in either or both of the first two plan years ending on or after June 30, 2008, as an experience loss separate from other experience losses. Under the relief provision, such net experience loss is then amortized in equal annual installments (until fully amortized) over the period beginning with the plan year for which the allocable portion is determined, and ending with the last plan year in the 30-plan year period beginning with the plan year following the plan year in which such net investment loss was incurred.

The net investment loss incurred by a plan in a plan year is equal to the excess of the expected value of the assets as of the end of the plan year, over the market value of the assets as of the end of the plan year, including any difference attributable to a criminally fraudulent investment arrangement. The expected value of the assets as of the end of a plan year is the amount of the excess of (1) the amount of the market value of the assets at the beginning of the plan year plus contributions made during the plan year, over (2) the amount of disbursements made during the plan year. The amounts in (1) and (2) are adjusted with interest at the plan's valuation rate to the end of the plan year. In calculating net investment loss, the determination as to whether an arrangement is a criminally fraudulent investment arrangement is to be made under rules substantially similar to the rules prescribed by the Secretary for purposes of section 165.

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<sup>428</sup> Sec. 4971. Special rules apply under section 4971 for multiemployer plans in endangered or critical status.

To determine the allocable portion of net experience losses for a plan year, the net investment loss incurred in a plan year is allocated among the five plan years following the plan year in which the investment loss is incurred in accordance with the following schedule table:

**Determination of Allocable Portion of Net Investment Losses**

<b>Plan year after the plan year in which the net investment loss was incurred</b>	<b>Allocable portion of net investment loss before reflecting interest adjustment</b>
First	One half
Second	Zero
Third	One sixth
Fourth	One sixth
Fifth	One sixth

The 30 year-period over which the allocable portion of such net experiences determined under this schedule is amortized is reduced for each year that has elapsed after the first year. The amount of the allocable portion of the net investment loss determined under the above table is increased with interest at the valuation rate for the plan from the plan year after the plan year in which the net investment was incurred. Thus, for example, for a plan with a calendar year plan year, if the plan sponsor uses this relief provision with respect to the net experience losses incurred in the 2008 plan year the following schedule applies : for the 2009 plan year, one half of the net experience loss incurred in the 2008 plan year (with no adjustment for interest) is the allocable portion and such portion is amortized over 30 years; for 2010, there is no allocable portion of such loss for the plan year; for the 2011 plan year, one sixth of such loss increased for interest for the 2 years that have elapsed since the first year is the allocable portion and such portion is amortized over 28 years; for 2012, one sixth of such loss increased for interest for the 3 years that have elapsed since the first year is the allocable portion and is amortized over 27 years; and for 2013, one sixth of such loss increased for interest for the 3 years that have elapsed since the first year is the allocable portion and such portion is amortized over 26 years.

If, for a plan year, there is an experience loss for the plan (when the plan's experience loss is calculated under the plan's asset valuation method without regard to this relief provision) and the portion of the net investment losses incurred in a plan year for which this relief provision is elected that is allocated for the plan year in accordance with the above schedule exceeds the total amount of the experience loss for the plan year, then the excess is treated as an experience gain for the plan year, amortized over 15 years in a separate amortization base in accordance with section 431. If however, for a plan year, there is either no experience gain or loss, or an experience gain for the plan, then the amount of the experience gain, if any, is increased by the portion of the net investment losses incurred in a plan year for which this relief provision is elected that is allocated for the plan year in accordance with the above. If relief is elected with respect to net losses incurred in both of the first two plan years ending on or after June 30, 2008, the sum of the relevant allocable portions for the plan years are used in the calculation of the amount of experience gain that is amortized over 15 years.

These rules are illustrated by the following example: The plan sponsor for a plan with a calendar year plan year makes an election to use this relief provision to amortize the net investment losses for 2008 over 30 years but does not elect to the relief for net investment losses for 2009. The 2008 net investment loss is \$60,000,000. The funding valuation method of the multiemployer plan spreads the difference between expected returns and actual returns over five years. The plan's valuation interest rate is 7 percent.<sup>429</sup> The following chart shows the calculation of the allocable portion of 2008 net investment losses with interest for each year 2009 through 2013.

**Calculation of the Allocable Portion of 2008 Net Investment Losses  
with Interest for Each Year 2009 through 2013**

<b>Plan year</b>	<b>Allocable portion of net investment loss</b>	<b>Allocable portion of 2008 net investment loss</b>	<b>Years of interest</b>	<b>Interest</b>	<b>Allocable portion of 2008 net investment loss with interest</b>
2009	One half	\$30,000,000	Zero	\$0.00	\$30,000,000
2010	Zero	0	One	\$0.00	\$0
2011	One sixth	\$10,000,000	Two	\$1,449,000	\$11,449,000
2012	One sixth	\$10,000,000	Three	\$2,250,430	\$12,250,430
2013	One sixth	\$10,000,000	Four	\$3,107,960	\$13,107,960

The following three scenarios for 2009 and 2011 illustrate the interaction between the allocable portion of 2008 investment losses and the experience gains<sup>430</sup> and losses determined under the plan using the plan's valuation method (determined without regard to the special relief provision).

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<sup>429</sup> It is assumed, for purposes of this example, that seven percent is a reasonable interest rate.

<sup>430</sup> Gains are indicated in the example by the use of parenthesis.

**Amortization bases that first are set up in 2009 funding standard account**

If total experience base that would otherwise be set up is:	Scenario 1		Scenario 2		Scenario 3	
	Amortization bases	Amortization period	Amortization bases	Amortization period	Amortization bases	Amortization period
(1) Total experience loss/(gain) for 2009	\$35,000,000	N/A	\$25,000,000	N/A	(\$1,000,000)	N/A
(2) Portion attributable to 2008 net investment loss	- \$30,000,000	30	- \$30,000,000	30	- \$30,000,000	30
(3) Balancing loss/(gain) base [(1) - (2)]	\$5,000,000	15	(\$5,000,000)	15	(\$31,000,000)	15

**Amortization bases that first are set up in 2011 funding standard account**

If total experience base that would otherwise be set up is:	Scenario 1		Scenario 2		Scenario 3	
	Amortization bases	Amortization period	Amortization bases	Amortization period	Amortization bases	Amortization period
(1) Total experience loss/(gain) for 2011	\$15,000,000	N/A	\$5,000,000	N/A	(\$18,000,000)	N/A
(2) Portion attributable to 2008 net investment loss	- \$11,449,000	28	- \$11,449,000	28	- \$11,449,000	28
(3) Balancing loss/(gain) base [(1) - (2)]	\$3,551,000	15	(\$6,449,000)	15	(\$29,449,000)	15

**Amortization extensions**

No extension of the amortization period for the allocable share of net experience losses is allowed under section 431(d) for plan sponsors who elect to take advantage of these relief provisions, and if an extension was granted under section 431(d) before the plan year for which this relief is elected, such extension must not result in the amortization period under this relief provision exceeding 30 years (or the shorter period for plan years after the year immediately following the year in which the net investment losses are incurred (such as 28 years for 2011 with respect to 2008 net investment losses)).

**Solvency test**

The solvency test is satisfied if, in connection with the election of this relief, the plan's actuary certifies that the plan is projected to have a funded percentage at the end of the first 15 plan years in the 30-year amortization period that is not less than 100 percent of the funded percentage for the plan year of the election. For this purpose, the funded percentage has the meaning provided in section 432(i)(2), except that the value of plan's assets referred to in section 432(i)(2)(A) is the market value of such assets.

In making any certification under this solvency test, the plan's actuary must use the same actuarial estimates, assumptions, and methods as those applicable for the most recent certifications (including any concurrent recertification) under section 432(b)(3), except that the plan's actuary may take into account benefit reductions and increases in contribution rates, under either a funding improvement plan or a rehabilitation plan, that the plan's actuary reasonably anticipates will occur without regard to any change in status of the plan resulting from the election.

### Limitation on amendments increasing benefits

If an election is made under this relief provision, then, in addition to any other applicable restrictions on benefit increases, a plan amendment which is adopted on or after March 10, 2010, and which increases benefits, may not go into effect during the period beginning on such date and ending with the second plan year beginning after such date unless the actuary makes certain certifications with respect to the increase in benefits from the amendment. Unless the amendment is required as a condition of qualification under section 401(a), or to comply with other applicable law, the plan's actuary must certify that any such increase is paid for out of additional contributions not allocated to the plan immediately before the election to use this funding relief provision is made, and the plan's funded percentage and projected credit balances for the first three plan years ending on or after March 10, 2010, are reasonably expected to be at least as high as such percentage and balances would have been if the benefit increase had not been adopted.

### Form and timing of elections

The deadline for electing this relief is June 30, 2011. A plan sponsor may elect to use this relief provision at such time and in such form and manner as prescribed by the Secretary.

### Reporting of elections to use relief provision

A plan sponsor that elects 30-year amortization under this relief provision must give notice of such election to participants and beneficiaries of the plan, and inform the Pension Benefit Guaranty Corporation of such election in a form and manner prescribed by the Director of the Pension Benefit Guaranty Corporation.

### Automatic approval for change in funding method

In the case of a plan for which this relief is elected, any change is the plan's funding method from a method that does not establish a base for experience gains and losses to a funding method that does establish such a base is treated as approved by the Secretary, and any resulting funding method change base is treated for purposes of amortization as a net experience loss or gain. This automatic approval applies to a change for any plan year beginning on or after July 1, 2008 and on or before December 31, 2010.

### **Asset smoothing**

Under the provision, the Secretary may not treat the asset valuation method of a multiemployer plan as unreasonable solely because such method spreads the difference between expected returns and actual returns for either or both of the first two plan years ending after June 30, 2008, over a period of not more than ten years. In addition, any change in valuation method to provide for such spreading will be treated as approved, but only if any resulting change in the plan's asset value for the first plan year of the change in funding method as a result of also electing 30 year amortization of net investment losses in either or both of the first two plan years ending on or after June 30, 2008, is treated for purposes of amortization as a net experience loss or gain.

If the plan sponsor of the plan that uses such a valuation method also elects to use the 30-year amortization option described above with respect to losses incurred in one or both plan years ending on or after June 30, 2008, the schedule for determining the allocable portion of such net losses is adjusted to reflect the longer smoothing period. Under the schedule, the allocable portions for the first two years are the same fractions (half of the net experience loss is allocated to the first year of the period and no portion of the experience loss is allocated the second year in the period). With respect to the remainder of the period after the second year, the half of the net experience loss otherwise allocated in equal portions for years three through five under the chart above is instead allocated in equal portions over the remainder of the years of the period. Corresponding changes are made to the amortization periods and the interest adjustments. For example, for a plan that extends to 10 years the period for asset smoothing for these two plan years, the allocable portion of the net investment losses in the tenth year is 1/16 and the allocable share is adjusted for nine years of interest.

The same rules apply to the interaction between the allocable portion of investment losses under the relief provision and the experience gains and losses determined under the plan using the plan's valuation method (determined without regard to the special relief provision) as apply in the case of a plan that spread spreads the difference between expected returns and actual returns for either or both of the first two plan years ending after June 30, 2008, over a period of not more than five years. Thus, if, for a plan year, there is an experience loss for the plan (when the plan's experience loss is calculated under the plan's asset valuation method without regard to this special relief provisions) and the allocable portion of the net investment losses incurred in a plan year for which this relief provision is elected exceeds the total amount of the experience loss for the plan year, then the excess is treated as an experience gain for the plan year, amortized over 15 years in a separate amortization base in accordance with section 431. Similarly if, for a plan year, there is an experience gain, the experience gain is increased by allocable portion of the net investment. If relief is elected with respect to net losses incurred in both of the first two plan years ending on or after June 30, 2008, the sum of the relevant allocable portions for the plan year are used in the calculation of the amount of experience gain.

### **Effective Date**

The provision takes effect as of the first day of the first plan year beginning after June 30, 2008, except that any election a plan sponsor makes pursuant to the provision that affects the plan's funding standard account for any plan year beginning before October 1, 2009, is disregarded for purposes of applying the additional funding rules for multiemployer plans in endangered or critical status to that plan year.

**G. Optional Longer Recovery Periods for Multiemployer Plans  
in Endangered or Critical Status  
(sec. 312 of the bill and sec. 432 of the Code)**

**Present Law**

**Additional funding rules for plans in endangered or critical status**

Under section 432,<sup>431</sup> additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of and compliance with: (1) a funding improvement plan in the case of a multiemployer plan in endangered status; and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional contributions and benefit reductions may apply and employers generally are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Section 432 is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015 must continue to operate under such plan until the funding improvement or rehabilitation plan is no longer in effect.

**Plans in endangered status**

**Determination of endangered status**

Not later than the 90th day of each plan year, the plan actuary must certify to the Secretary and to the plan sponsor whether or not the plan is in endangered or critical status for the plan year.<sup>432</sup> A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year: (1) the plan's funded percentage for the plan year is less than 80 percent; or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over the accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

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<sup>431</sup> Parallel rules apply under ERISA.

<sup>432</sup> Failure of the plan's actuary to certify the status of the plan is treated as a failure to file the annual report (thus, an ERISA penalty of up to \$1,100 per day for each day of the failure applies). If a plan is certified to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to the participants and beneficiaries, the bargaining parties, the PBGC, and the Secretary of Labor.

### Funding improvement plan

In the case of a multiemployer plan in endangered status, a funding improvement plan must be adopted within 240 days following the deadline for certifying a plan's status.<sup>433</sup> A funding improvement plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements. The funding improvement plan must provide that during the funding improvement period, the plan will have a specified required increase in the funded percentage<sup>434</sup> and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the "applicable benchmarks"). Once a funding improvement plan has been adopted, the plan sponsor must annually update the funding improvement plan and must file the update with the plan's annual report.

Within 30 days after the adoption of the funding improvement plan, the plan sponsor must provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan. These options must include one provision for reductions in the amount of future benefit accruals necessary to achieve the applicable benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing contributions necessary to achieve the applicable benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law), and one provision for increases in contributions under the plan necessary to achieve the applicable benchmarks, assuming no amendments reducing future benefit accruals under the plan. The first of these two provisions is the default if the bargaining parties fail to adopt a schedule of contribution rates and related benefit rates consistent with the funding improvement plan. If the plan sponsor deems appropriate, the plan sponsor may also prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to achieving the applicable benchmarks in accordance with the funding improvement plan.

### Funding improvement period

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of: (1) the second anniversary of the date of adoption of the funding improvement plan; or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial determination year and covering, as of such date, at least 75 percent of the plan's active

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<sup>433</sup> This requirement applies for the initial determination year (i.e., the first plan year that the plan is in endangered status).

<sup>434</sup> In general, the plan must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-third during the funding improvement period. A plan in seriously endangered status generally must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-fifth during the funding improvement period.



participants. In the case of a plan in seriously endangered status, a 15-year funding improvement period generally is used. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

Certain restrictions apply from the date of certification until the end of the funding improvement period. During the period prior to the approval of a funding improvement plan, subject to certain exceptions, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable. In addition, following the date the plan is certified to be in endangered status through the end of the funding improvement period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for: (1) a reduction in the level of contributions for participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Upon adoption of a funding improvement plan, the multiemployer plan may not be amended to be inconsistent with the funding improvement plan or to increase future benefit accruals, unless the plan actuary certifies in advance that the benefit increase is consistent with the funding improvement plan and will be paid for out of contributions not required by the funding improvement plan in order to meet the applicable benchmarks in accordance with the schedule contemplated in the funding improvement plan.

#### Excise tax

If the funding improvement plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In the case of a plan in seriously endangered status, an excise tax applies for the failure to meet the benchmarks by the end of the funding improvement period. In such case, an excise tax applies based on the greater of: (1) the amount of the contributions necessary to meet such benchmarks; or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the benchmarks are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to achieve the applicable benchmarks. The party against whom the tax is imposed has the burden of establishing that the failure was due to reasonable cause and not willful neglect.

In the case of a plan in endangered status, which is not in seriously endangered status, a civil penalty of \$1,100 per day applies for the failure of the plan to meet the applicable benchmarks by the end of the funding improvement period.

#### **Plans in critical status**

##### Determination of critical status

A multiemployer plan is in critical status for a plan year if, as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all nonforfeitable benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses);
2. The plan (A) has an accumulated funding deficiency for the current plan year, not taking into account any amortization period extensions, or (B) is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization period extensions;
3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding plan year, exceeds the present value of the reasonably anticipated employer and employee contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions); or
4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

#### Rehabilitation plan

If a plan is in critical status for a plan year, the plan sponsor must adopt a rehabilitation plan within 240 days following the required date for the actuarial certification of critical status.<sup>435</sup> A rehabilitation plan is a plan which consists of actions, including options or a range of options to be proposed to the bargaining parties, formulated to enable, based on reasonably anticipated experience and reasonable actuarial assumptions, the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefit accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions. A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation plan. A summary of the rehabilitation plan and any modifications, together with

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<sup>435</sup> The requirement applies with respect to the initial critical year.

annual updates regarding the funding ratio of the plan, must be included in the annual report and summary annual report for the plan year.

If the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

Within 30 days after the adoption of the rehabilitation plan, the plan sponsor must provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan. If the plan sponsor deems appropriate, the plan sponsor may prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to emerging from critical status in accordance with the rehabilitation plan.

The schedule or schedules described must reflect reductions in future benefit accruals and adjustable benefits, and increases in contributions, that the plan sponsor determines are reasonably necessary to emerge from critical status. One schedule must be designated as the default schedule and such schedule must assume that there are no increases in contributions under the plan other than the increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under section 411(d)(6)) have been reduced to the maximum extent permitted by law.

#### Rehabilitation period

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of: (1) the second anniversary of the date of adoption of the rehabilitation plan; or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan. The rehabilitation period ends if the plan emerges from critical status.

Certain restrictions apply from the date of certification until the end of the rehabilitation period. For example, beginning on the date that notice of certification of the plan's critical status is sent, lump sum and other similar benefits may not be paid.<sup>436</sup> In addition, following the date the plan is certified to be in critical status through the end of the rehabilitation period, the plan

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<sup>436</sup> The restriction does not apply if the present value of the participant's accrued benefit does not exceed \$5,000. The restriction also does not apply to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

sponsor may not accept a collective bargaining agreement or participation agreement that provides for: (1) a reduction in the level of contributions for participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Once a rehabilitation plan has been adopted, the plan may not be amended to be inconsistent with the rehabilitation plan or to increase benefits, including future benefit accruals, unless the plan actuary certifies that the increase is paid for out of additional contributions not contemplated by the rehabilitation plan, and, after taking into account the benefit increase, the multiemployer plan still is reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated in the rehabilitation plan.

#### Excise tax

In the case of a plan in critical status, if the employers adopt and comply with a rehabilitation plan, they are not liable for contributions otherwise required under the general funding rules and the excise tax on failures to make such contributions generally does not apply. If, however, the rehabilitation plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In addition, if a plan fails to leave critical status at the end of the rehabilitation period or fails to make scheduled progress in meeting its requirements under the rehabilitation plan for three consecutive years, the excise tax applies based on the greater of: (1) the amount of the contributions necessary to leave critical status or make scheduled progress; or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the requirements are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to leave critical status by the end of the rehabilitation period or make scheduled progress.

#### **Elections permitted under WRERA**

Under WRERA, for the first plan year beginning during the period from October 1, 2008, through September 30, 2009, the sponsor of a multiemployer defined benefit pension plan is permitted to elect to treat the plan's status for purposes of section 432 the same as the plan's status for the preceding plan year. Thus, for example, a calendar year plan that is not in critical or endangered status for 2008 may elect to retain its non-critical and non-endangered status for 2009, and a plan that was in either critical or endangered status for 2008 may elect to retain such status for 2009. If section 432 did not apply to a plan for the year preceding the applicable plan year, the plan's sponsor may elect to treat the plan's status for the applicable plan year as the status that would have applied to the plan had section 432 applied for the preceding plan year.

Such an election may only be revoked with the consent of the Secretary and special notice provisions apply with respect to the election and the notification of participants, the bargaining parties, the PBGC, and the Secretary of Labor.<sup>437</sup>

A plan that elects to retain its endangered or critical status is not required to update its funding improvement or rehabilitation plan until the plan year that follows the applicable plan year. If an election is made by a plan and, without regard to the election, the plan is certified by the plan's actuary for the applicable plan year to be in critical status, the plan is treated as a plan in critical status for purposes of the special rules that relieve contributing employers from liability for minimum required contributions (that would apply under the otherwise applicable minimum funding rules) and the excise tax that applies in the case of a failure to make such contributions.

In addition, under WRERA, a plan sponsor of a multiemployer defined benefit pension plan may elect for a plan year beginning in 2008 or 2009 to extend the plan's otherwise applicable funding improvement or rehabilitation period by three years.

### **Explanation of Provision**

Under the provision, the plan sponsor of a multiemployer defined benefit pension plan in endangered status (including seriously endangered status) or critical status may elect to extend the plan's otherwise applicable funding improvement or rehabilitation period by up to five years, reduced by any extension of the period previously elected under WRERA. Plan sponsor elections are required to be made, in such form and manner as the Secretary prescribes, not later than June 30, 2011.

### **Effective Date**

The provision applies with respect to funding improvement periods and rehabilitation periods in connection with funding improvement plans and rehabilitation plans adopted or updated on or after the date of enactment.

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<sup>437</sup> See Notices 2009-31 and 2009-42 for IRS guidance on the election and notice procedures that apply when a plan sponsor makes an election to retain its critical or endangered status under WRERA. See Rev. Proc. 2009-43 for IRS guidance on the revocation of such an election.

## **H. Modification of Certain Amortization Extensions Under Prior Law (sec. 313 of the bill)**

### **Present Law**

#### **The Pre-PPA minimum funding rules**

##### **In general**

Prior to the enactment of the PPA, defined benefit multiemployer plans generally were subject to the same general minimum funding rules as single-employer plans. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement.

A multiemployer defined benefit pension plan was required to maintain a special account called a “funding standard account” to which charges and credits (such as credits for plan contributions) were made for each plan year. If, as of the close of the plan year, charges to the funding standard account exceeded credits to the account, the plan had an “accumulated funding deficiency” equal to the amount of such excess charges. For example, if the balance of charges to the funding standard account of a plan for a year would be \$200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If credits to the funding standard account exceeded charges, a “credit balance” resulted. The amount of the credit balance, increased with interest, could be used to reduce future required contributions.

A plan was required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an acceptable actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as the: (1) normal cost and (2) amortization of supplemental cost. The normal cost for a plan for a plan year generally represented the cost of future benefits allocated to the plan year under the funding method used by the plan for current employees. The supplemental cost for a plan year was the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets, such as a net experience loss. Supplemental costs were amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. In the case of a multiemployer plan, past service liability was amortized over 30 or 40 years depending on how the liability arose,<sup>438</sup> experience gains and losses were amortized over 15 years, gains and losses from changes in actuarial assumptions were amortized over 30 years, and waived funding deficiencies were amortized over 15 years.

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<sup>438</sup> In the case of a plan in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 40 years. In the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 30 years. Past service liability due to plan amendments was amortized over 30 years.

### Amortization extensions by the Secretary

Amortization periods could be extended for up to 10 years by the Secretary if the Secretary found that the extension would carry out the purposes of ERISA and would provide adequate protection for participants under the plan and if the Secretary determined that the failure to permit such an extension would: (1) result in a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or employee compensation; and (2) be adverse to the interests of plan participants in the aggregate.

### **Explanation of Provision**

Under the provision, in the case of an amortization extension granted to a multiemployer defined benefit plan under the minimum funding rules as in effect immediately prior to the enactment of the PPA, the determination of whether any financial condition on the amortization extension is satisfied is made by assuming that for any plan year that contains some or all of the period beginning June 30, 2008 and ending October 31, 2008, the actual rate of return on plan assets is equal to the interest rate used for purposes of charging or crediting the funding standard account in such plan year, unless the plan sponsor elects otherwise in such form and manner as is prescribed by the Secretary. Under the provision, the plan sponsor of a multiemployer defined benefit plan may revoke the previously granted amortization extension election, in such form and manner and after such notice as may be prescribed by the Secretary, effective for plan years following the date of revocation.

### **Effective Date**

The provision is effective as of the date of enactment.

**I. Alternative Default Schedule for Plans in Endangered or Critical Status**  
**(sec. 314 of the bill and sec. 432 of the Code)**

**Present law**

**Additional funding rules for plans in endangered or critical status**

Under section 432,<sup>439</sup> additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of and compliance with: (1) a funding improvement plan in the case of a multiemployer plan in endangered status; and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional contributions and benefit reductions may apply and employers generally are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Section 432 is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015 must continue to operate under such plan until the funding improvement or rehabilitation plan is no longer in effect.

**Plans in endangered status**

**Determination of endangered status**

Not later than the 90th day of each plan year, the plan actuary must certify to the Secretary and to the plan sponsor whether or not the plan is in endangered or critical status for the plan year.<sup>440</sup> A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year: (1) the plan's funded percentage for the plan year is less than 80 percent; or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over the accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

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<sup>439</sup> Parallel rules apply under ERISA.

<sup>440</sup> Failure of the plan's actuary to certify the status of the plan is treated as a failure to file the annual report (thus, an ERISA penalty of up to \$1,100 per day for each day of the failure applies). If a plan is certified to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to the participants and beneficiaries, the bargaining parties, the PBGC, and the Secretary of Labor.



### Funding improvement plan

In the case of a multiemployer plan in endangered status, a funding improvement plan must be adopted within 240 days following the deadline for certifying a plan's status.<sup>441</sup> A funding improvement plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements. The funding improvement plan must provide that during the funding improvement period, the plan will have a specified required increase in the funded percentage<sup>442</sup> and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the "applicable benchmarks"). Once a funding improvement plan has been adopted, the plan sponsor must annually update the funding improvement plan and must file the update with the plan's annual report.

Within 30 days after the adoption of the funding improvement plan, the plan sponsor must provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan. These options must include one provision for reductions in the amount of future benefit accruals necessary to achieve the applicable benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing contributions necessary to achieve the applicable benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law), and one provision for increases in contributions under the plan necessary to achieve the applicable benchmarks, assuming no amendments reducing future benefit accruals under the plan. The first of these two provisions is the default if the bargaining parties fail to adopt a schedule of contribution rates and related benefit rates consistent with the funding improvement plan. If the plan sponsor deems appropriate, the plan sponsor may also prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to achieving the applicable benchmarks in accordance with the funding improvement plan.

### Funding improvement period

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of: (1) the second anniversary of the date of adoption of the funding improvement plan; or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial determination year and covering, as of such date, at least 75 percent of the plan's active

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<sup>441</sup> This requirement applies for the initial determination year (i.e., the first plan year that the plan is in endangered status).

<sup>442</sup> In general, the plan must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-third during the funding improvement period. A plan in seriously endangered status generally must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-fifth during the funding improvement period.

participants. In the case of a plan in seriously endangered status, a 15-year funding improvement period generally is used. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

Certain restrictions apply from the date of certification until the end of the funding improvement period. During the period prior to the approval of a funding improvement plan, subject to certain exceptions, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable. In addition, following the date the plan is certified to be in endangered status through the end of the funding improvement period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for: (1) a reduction in the level of contributions for participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Upon adoption of a funding improvement plan, the multiemployer plan may not be amended to be inconsistent with the funding improvement plan or to increase future benefit accruals, unless the plan actuary certifies in advance that the benefit increase is consistent with the funding improvement plan and will be paid for out of contributions not required by the funding improvement plan in order to meet the applicable benchmarks in accordance with the schedule contemplated in the funding improvement plan.

#### Excise tax

If the funding improvement plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In the case of a plan in seriously endangered status, an excise tax applies for the failure to meet the benchmarks by the end of the funding improvement period. In such case, an excise tax applies based on the greater of: (1) the amount of the contributions necessary to meet such benchmarks; or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the benchmarks are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to achieve the applicable benchmarks. The party against whom the tax is imposed has the burden of establishing that the failure was due to reasonable cause and not willful neglect.

In the case of a plan in endangered status, which is not in seriously endangered status, a civil penalty of \$1,100 per day applies for the failure of the plan to meet the applicable benchmarks by the end of the funding improvement period.

#### **Plans in critical status**

##### Determination of critical status

A multiemployer plan is in critical status for a plan year if, as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all nonforfeitable benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses);
2. The plan (A) has an accumulated funding deficiency for the current plan year, not taking into account any amortization period extensions, or (B) is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization period extensions;
3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding plan year, exceeds the present value of the reasonably anticipated employer and employee contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions); or
4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

#### Rehabilitation plan

If a plan is in critical status for a plan year, the plan sponsor must adopt a rehabilitation plan within 240 days following the required date for the actuarial certification of critical status.<sup>443</sup> A rehabilitation plan is a plan which consists of actions, including options or a range of options to be proposed to the bargaining parties, formulated to enable, based on reasonably anticipated experience and reasonable actuarial assumptions, the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefit accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions. A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation plan. A summary of the rehabilitation plan and any modifications, together with

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<sup>443</sup> The requirement applies with respect to the initial critical year.

annual updates regarding the funding ratio of the plan, must be included in the annual report and summary annual report for the plan year.

If the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

Within 30 days after the adoption of the rehabilitation plan, the plan sponsor must provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan. If the plan sponsor deems appropriate, the plan sponsor may prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to emerging from critical status in accordance with the rehabilitation plan.

The schedule or schedules described must reflect reductions in future benefit accruals and adjustable benefits, and increases in contributions, that the plan sponsor determines are reasonably necessary to emerge from critical status. One schedule must be designated as the default schedule and such schedule must assume that there are no increases in contributions under the plan other than the increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under section 411(d)(6)) have been reduced to the maximum extent permitted by law.

#### Rehabilitation period

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of: (1) the second anniversary of the date of adoption of the rehabilitation plan; or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan. The rehabilitation period ends if the plan emerges from critical status.

Certain restrictions apply from the date of certification until the end of the rehabilitation period. For example, beginning on the date that notice of certification of the plan's critical status is sent, lump sum and other similar benefits may not be paid.<sup>444</sup> In addition, following the date the plan is certified to be in critical status through the end of the rehabilitation period, the plan

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<sup>444</sup> The restriction does not apply if the present value of the participant's accrued benefit does not exceed \$5,000. The restriction also does not apply to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

sponsor may not accept a collective bargaining agreement or participation agreement that provides for: (1) a reduction in the level of contributions for participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Once a rehabilitation plan has been adopted, the plan may not be amended to be inconsistent with the rehabilitation plan or to increase benefits, including future benefit accruals, unless the plan actuary certifies that the increase is paid for out of additional contributions not contemplated by the rehabilitation plan, and, after taking into account the benefit increase, the multiemployer plan still is reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated in the rehabilitation plan.

#### Excise tax

In the case of a plan in critical status, if the employers adopt and comply with a rehabilitation plan, they are not liable for contributions otherwise required under the general funding rules and the excise tax on failures to make such contributions generally does not apply. If, however, the rehabilitation plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In addition, if a plan fails to leave critical status at the end of the rehabilitation period or fails to make scheduled progress in meeting its requirements under the rehabilitation plan for three consecutive years, the excise tax applies based on the greater of: (1) the amount of the contributions necessary to leave critical status or make scheduled progress; or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the requirements are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to leave critical status by the end of the rehabilitation period or make scheduled progress.

#### **Elections permitted under WRERA**

Under WRERA, for the first plan year beginning during the period from October 1, 2008, through September 30, 2009, the sponsor of a multiemployer defined benefit pension plan is permitted to elect to treat the plan's status for purposes of section 432 the same as the plan's status for the preceding plan year. Thus, for example, a calendar year plan that is not in critical or endangered status for 2008 may elect to retain its non-critical and non-endangered status for 2009, and a plan that was in either critical or endangered status for 2008 may elect to retain such status for 2009. If section 432 did not apply to a plan for the year preceding the applicable plan year, the plan's sponsor may elect to treat the plan's status for the applicable plan year as the status that would have applied to the plan had section 432 applied for the preceding plan year.

Such an election may only be revoked with the consent of the Secretary and special notice provisions apply with respect to the election and the notification of participants, the bargaining parties, the PBGC, and the Secretary of Labor.<sup>445</sup>

A plan that elects to retain its endangered or critical status is not required to update its funding improvement or rehabilitation plan until the plan year that follows the applicable plan year. If an election is made by a plan and, without regard to the election, the plan is certified by the plan's actuary for the applicable plan year to be in critical status, the plan is treated as a plan in critical status for purposes of the special rules that relieve contributing employers from liability for minimum required contributions (that would apply under the otherwise applicable minimum funding rules) and the excise tax that applies in the case of a failure to make such contributions.

In addition, under WRERA, a plan sponsor of a multiemployer defined benefit pension plan may elect for a plan year beginning in 2008 or 2009 to extend the plan's otherwise applicable funding improvement or rehabilitation period by three years.

### **Explanation of Provision**

Under the provision, a plan sponsor of a multiemployer plan may, in adopting a funding improvement plan for a plan in endangered status, or a rehabilitation plan for a plan in critical status, designate an alternative schedule of contribution rates and related benefit changes as the default schedule in lieu of the default schedule otherwise required. The alternative schedule designated must have been adopted in collective bargaining agreements covering at least 75 percent of the active participants as of the date of the designation.

### **Effective Date**

This provision applies to designations of default schedules by plan sponsors on or after the date of enactment.<sup>446</sup>

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<sup>445</sup> See Notices 2009-31 and 2009-42 for IRS guidance on the election and notice procedures that apply when a plan sponsor makes an election to retain its critical or endangered status under WRERA. See Rev. Proc. 2009-43 for IRS guidance on the revocation of such an election.

<sup>446</sup> As noted above in the description of present law, the additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015 must continue to operate under such plan until the funding improvement or rehabilitation plan is no longer in effect.

## **J. Transition Rule for Certifications of Plan Status (sec. 315 of the bill)**

### **Present Law**

#### **Additional funding rules for plans in endangered or critical status**

Under section 432,<sup>447</sup> additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of and compliance with: (1) a funding improvement plan in the case of a multiemployer plan in endangered status; and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional contributions and benefit reductions may apply and employers generally are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Section 432 is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015 must continue to operate under such plan until the funding improvement or rehabilitation plan is no longer in effect.

#### **Plans in endangered status**

##### **Determination of endangered status**

Not later than the 90th day of each plan year, the plan actuary must certify to the Secretary and to the plan sponsor whether or not the plan is in endangered or critical status for the plan year.<sup>448</sup> A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year: (1) the plan's funded percentage for the plan year is less than 80 percent; or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over the accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

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<sup>447</sup> Parallel rules apply under ERISA.

<sup>448</sup> Failure of the plan's actuary to certify the status of the plan is treated as a failure to file the annual report (thus, an ERISA penalty of up to \$1,100 per day for each day of the failure applies). If a plan is certified to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to the participants and beneficiaries, the bargaining parties, the PBGC, and the Secretary of Labor.

### Funding improvement plan

In the case of a multiemployer plan in endangered status, a funding improvement plan must be adopted within 240 days following the deadline for certifying a plan's status.<sup>449</sup> A funding improvement plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements. The funding improvement plan must provide that during the funding improvement period, the plan will have a specified required increase in the funded percentage<sup>450</sup> and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the "applicable benchmarks"). Once a funding improvement plan has been adopted, the plan sponsor must annually update the funding improvement plan and must file the update with the plan's annual report.

Within 30 days after the adoption of the funding improvement plan, the plan sponsor must provide to the bargaining parties one or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan. These options must include one provision for reductions in the amount of future benefit accruals necessary to achieve the applicable benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing contributions necessary to achieve the applicable benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law), and one provision for increases in contributions under the plan necessary to achieve the applicable benchmarks, assuming no amendments reducing future benefit accruals under the plan. The first of these two provisions is the default if the bargaining parties fail to adopt a schedule of contribution rates and related benefit rates consistent with the funding improvement plan. If the plan sponsor deems appropriate, the plan sponsor may also prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to achieving the applicable benchmarks in accordance with the funding improvement plan.

### Funding improvement period

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of: (1) the second anniversary of the date of adoption of the funding improvement plan; or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial

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<sup>449</sup> This requirement applies for the initial determination year (i.e., the first plan year that the plan is in endangered status).

<sup>450</sup> In general, the plan must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-third during the funding improvement period. A plan in seriously endangered status generally must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-fifth during the funding improvement period.



determination year and covering, as of such date, at least 75 percent of the plan's active participants. In the case of a plan in seriously endangered status, a 15-year funding improvement period generally is used. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

Certain restrictions apply from the date of certification until the end of the funding improvement period. During the period prior to the approval of a funding improvement plan, subject to certain exceptions, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable. In addition, following the date the plan is certified to be in endangered status through the end of the funding improvement period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for: (1) a reduction in the level of contributions for participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Upon adoption of a funding improvement plan, the multiemployer plan may not be amended to be inconsistent with the funding improvement plan or to increase future benefit accruals, unless the plan actuary certifies in advance that the benefit increase is consistent with the funding improvement plan and will be paid for out of contributions not required by the funding improvement plan in order to meet the applicable benchmarks in accordance with the schedule contemplated in the funding improvement plan.

#### Excise tax

If the funding improvement plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In the case of a plan in seriously endangered status, an excise tax applies for the failure to meet the benchmarks by the end of the funding improvement period. In such case, an excise tax applies based on the greater of: (1) the amount of the contributions necessary to meet such benchmarks; or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the benchmarks are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to achieve the applicable benchmarks. The party against whom the tax is imposed has the burden of establishing that the failure was due to reasonable cause and not willful neglect.

In the case of a plan in endangered status, which is not in seriously endangered status, a civil penalty of \$1,100 per day applies for the failure of the plan to meet the applicable benchmarks by the end of the funding improvement period.

## **Plans in critical status**

### **Determination of critical status**

A multiemployer plan is in critical status for a plan year if, as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all nonforfeitable benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses);
2. The plan (A) has an accumulated funding deficiency for the current plan year, not taking into account any amortization period extensions, or (B) is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization period extensions;
3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding plan year, exceeds the present value of the reasonably anticipated employer and employee contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions); or
4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

### **Rehabilitation plan**

If a plan is in critical status for a plan year, the plan sponsor must adopt a rehabilitation plan within 240 days following the required date for the actuarial certification of critical status.<sup>451</sup> A rehabilitation plan is a plan which consists of actions, including options or a range of options to be proposed to the bargaining parties, formulated to enable, based on reasonably

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<sup>451</sup> The requirement applies with respect to the initial critical year.

anticipated experience and reasonable actuarial assumptions, the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefit accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions. A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation plan. A summary of the rehabilitation plan and any modifications, together with annual updates regarding the funding ratio of the plan, must be included in the annual report and summary annual report for the plan year.

If the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

Within 30 days after the adoption of the rehabilitation plan, the plan sponsor must provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan. If the plan sponsor deems appropriate, the plan sponsor may prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to emerging from critical status in accordance with the rehabilitation plan.

The schedule or schedules described must reflect reductions in future benefit accruals and adjustable benefits, and increases in contributions, that the plan sponsor determines are reasonably necessary to emerge from critical status. One schedule must be designated as the default schedule and such schedule must assume that there are no increases in contributions under the plan other than the increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under section 411(d)(6)) have been reduced to the maximum extent permitted by law.

#### Rehabilitation period

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of: (1) the second anniversary of the date of adoption of the rehabilitation plan; or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan. The rehabilitation period ends if the plan emerges from critical status.

Certain restrictions apply from the date of certification until the end of the rehabilitation period. For example, beginning on the date that notice of certification of the plan's critical status is sent, lump sum and other similar benefits may not be paid.<sup>452</sup> In addition, following the date the plan is certified to be in critical status through the end of the rehabilitation period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for: (1) a reduction in the level of contributions for participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Once a rehabilitation plan has been adopted, the plan may not be amended to be inconsistent with the rehabilitation plan or to increase benefits, including future benefit accruals, unless the plan actuary certifies that the increase is paid for out of additional contributions not contemplated by the rehabilitation plan, and, after taking into account the benefit increase, the multiemployer plan still is reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated in the rehabilitation plan.

#### Excise tax

In the case of a plan in critical status, if the employers adopt and comply with a rehabilitation plan, they are not liable for contributions otherwise required under the general funding rules and the excise tax on failures to make such contributions generally does not apply. If, however, the rehabilitation plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In addition, if a plan fails to leave critical status at the end of the rehabilitation period or fails to make scheduled progress in meeting its requirements under the rehabilitation plan for three consecutive years, the excise tax applies based on the greater of: (1) the amount of the contributions necessary to leave critical status or make scheduled progress; or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the requirements are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to leave critical status by the end of the rehabilitation period or make scheduled progress.

#### **Explanation of Provision**

Under the provision, in the case of any multiemployer plan for which the deadline for certifying whether or not the plan is in endangered or critical status is after the provision's date of enactment, the plan actuary will not be treated as failing to meet that deadline if the plan actuary provides such certification at any time earlier than 75 days after the provision's date of enactment. The provision is not intended to affect the otherwise applicable deadlines for the

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<sup>452</sup> The restriction does not apply if the present value of the participant's accrued benefit does not exceed \$5,000. The restriction also does not apply to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

adoption of a funding improvement or rehabilitation plan, or for the distribution of schedules to the bargaining parties, for a plan certified to be in endangered or critical status.

In addition, to the extent that a plan actuary's certification for a plan year did not take into account a plan sponsor's election to use a 30-year amortization period or an extended smoothing period, as permitted under section 311 of the bill, the plan sponsor may direct the plan actuary to make a new certification with respect to the plan for the plan year that takes into account such election, but only if the plan's status for purposes of section 432 would change as a result of the election. A plan that ceases to be in critical status pursuant to any permitted recertification is required, not later than 30 days following the due date for the recertification, to cease any restriction of benefit payments and any imposition of contribution surcharges that were imposed pursuant to the original certification.

Any recertification permitted by the provision must be made by the plan actuary not later than 75 days after the provision's date of enactment. Such recertification is treated for purposes of section 432 as the multiemployer plan's original certification for the plan year, except that a plan sponsor that has already provided notice of the plan's original certification of endangered or critical status to participants, beneficiaries, bargaining parties and the PBGC must provide notice of the plan's changed status to such parties under rules similar to those that apply to the provision of the original notice.

In addition, such recertification shall be treated as the most recent certification for purposes of determining which actuarial estimates, assumptions, and methods are used by the plan actuary in certifying that the multiemployer plan meets the solvency test for using a 30-year amortization period.<sup>453</sup>

### **Effective Date**

The provision is effective as of the date of enactment.

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<sup>453</sup> For a discussion of the solvency test and the optional use of 30-year amortization period, see the explanation of section 311 of the bill, "Optional Use of 30-Year Amortization Periods."

**K. Defined Contribution Fee Disclosure Act of 2010**  
**(secs. 323, 324 and 325 of the Bill and new secs. 4980J and 4980K of the Code)**

**Present Law**

**In General**

The Code provides favorable tax treatment for a variety of employer-sponsored retirement savings plans, provided that such plans meet certain qualification requirements (“qualified retirement plans”). A defined contribution plan is a qualified retirement plan under which each participant’s retirement benefit is equal to the participant’s allocable share of the trust that funds the plan. Under a defined contribution plan, each participant’s retirement benefit is increased by contributions to the trust and earnings on those contributions, and is decreased by losses on plan assets and fees paid from plan assets.

Employers who sponsor qualified retirement plans often contract with third parties who provide administrative and other services to the plan (e.g., maintenance of plan records). The Code generally does not restrict the fees that can be paid by a qualified retirement plan to a third-party service provider, or require the disclosure of fees incurred by the plans. There is an exception to this general rule for prohibited transactions, (discussed below).

Other, non-tax, rules may limit the amount of fees that may be charged to qualified retirement plans or require disclosure of such fees to plan sponsors and participants. For example, Federal and State banking rules, State insurance rules, Federal and State securities rules, and licensing rules applicable to professionals (such as attorneys and investment brokers or agents) may apply to certain plan service providers, depending on the services or investment alternatives offered.

ERISA also governs the fees that can be charged with respect to retirement plans.<sup>454</sup> For example, under ERISA, fiduciaries of a retirement plan are required to discharge their duties solely in the interest of the plan’s participants and beneficiaries and for the exclusive purpose of providing benefits to participants and defraying the “reasonable expenses of administering the plan.”<sup>455</sup> Thus, ERISA expressly permits the payment of fees in connection with plan administration, but requires that the fees be reasonable. ERISA also contains rules that require some disclosure of plan fees to plan participants.

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<sup>454</sup> Not all qualified retirement plans are subject to the fiduciary and disclosure rules of ERISA. For example, governmental retirement plans are exempt from these provisions. ERISA sec. 4(b)(1).

<sup>455</sup> ERISA sec. 404(a)(1)(A). The qualification rules under the Code contain a provision that is similar to this ERISA rule in that the trust holding the plan’s assets must be established for the exclusive purpose of providing plan benefits. See, for example, sec. 401(a). The Code’s prohibited transaction rules do not expressly describe the payment of fees, although the payment of reasonable expenses and fees paid with plan assets for the administration of the plan is not a violation of those rules. It is possible, in certain circumstances, that the payment of an unreasonable fee might violate the exclusive benefit rule.

## **Fees charged in connection with qualified retirement plans**

The fees incurred in connection with qualified retirement plans may be divided into three broad categories; fees related to: (1) plan administration; (2) specific services requested by plan participants; and (3) investment of plan assets. When these fees are paid from plan assets, the amount available under the plan for retirement benefits is reduced. For example, in the case of a section 401(k) plan where fees are paid by plan assets, each participant's account balance in the plan is reduced by the participant's allocable portion of the fees paid by the plan.

Fees related to plan administration include fees charged by attorneys and consultants for plan design, compliance with periodic reporting requirements, and participant communications (e.g., periodic benefits statements, summary plan descriptions, websites, and telephone service assistance). In general, these types of fees may be paid by the sponsoring employer or from plan assets.

Fees related to specific services requested by plan participants include fees charged in connection with loans to participants against the participants' interests in the plan, and the review of a court order to divide a participant's interest in the plan pursuant to a divorce decree. For a defined contribution plan, such fees are often charged against the participant's account balance.

Fees related to plan investments are typically paid from plan assets. Plan investment fees include any of the expenses associated with buying and selling investment assets, such as broker commissions, appraisal fees, attorneys' fees, and investment management fees. The following is a description of the fees typically charged in connection with common investment alternatives offered under participant-directed plans,<sup>456</sup> such as section 401(k) plans:

- **Mutual funds:** The manager of the mutual fund typically charges a management fee with respect to the assets of the fund which are paid out of the assets of the fund. In addition, some mutual funds provide for a sales charge with respect to each investment in the fund which is either paid upon initial investment (a "front-end load") or upon sale of the investment (a "back-end load"). Some funds charge "rule 12b-1" fees,<sup>457</sup> which are fees paid from the assets of a particular fund to cover broker commissions or promotional expenses.
- **Variable annuities:** An insurance company and an employer sponsoring a qualified retirement plan may enter into a group variable annuity contract, under which the insurance company offers investment options that may be chosen by plan participants.

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<sup>456</sup> See A Look at 401(k) Plan Fees, U.S. Department of Labor, Employee Benefits Security Administration. Available on the web at [www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html).

<sup>457</sup> Rule 12b-1 fees take their name from the Securities and Exchange Commission rule that permits a fund (such as a mutual fund) to pay such fees. Generally, the rule permits a fund to pay distribution fees out of a fund's assets only if the fund has adopted a plan permitting the payment of such fees. Distribution fees include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, and the printing and mailing of sales literature. See "Answers with Respect to Mutual Fund Fees and Expenses," Securities and Exchange Commission, available on the web at [www.sec.gov/answers/mffees.htm](http://www.sec.gov/answers/mffees.htm).

Some of the options may contain an insurance component which might include special fees. In addition, the variable annuity contract is typically subject to surrender and transfer charges if the employer terminates the group contract. Sometimes the amount of the surrender charge decreases over a specified time period, such that there is no charge (or a reduced amount) after the expiration of the time period.

- Collective investment funds and pooled guaranteed investment contract (“GIC”) funds: Collective investment funds are comprised of the pooled assets of various investors (e.g., two or more qualified plans participate in the fund) and are managed by a bank or trust company. A pooled GIC fund is issued by an insurance company or bank. A GIC is an insurance product that offers a specified rate of return over the life of the contract. A pooled GIC fund is a common method of providing a fixed income investment alternative to plan participants. Collective investment funds and pooled GIC funds involve management and administrative fee charges.

In general, the fees described above are negotiated by the employer that sponsors the plan. However, in some cases, the fees may not be subject to negotiation (e.g., front-end and back-end loads charged in connection with mutual funds). In addition, the total amount of fees paid, and the distinction between the types of fees being paid, may not be readily apparent to either the plan sponsor or participants. For example, as described above, it is possible that investment fees charged to plan assets may be used to pay for plan administration services, such that there is no separately stated fee (or a reduced fee). This particular practice is the subject of recent litigation.<sup>458</sup> The issue in most cases is whether the practice complies with the fiduciary requirements that apply to retirement plans.

### **Prohibited transaction rules**

#### **In general**

The Code’s prohibited transaction rules preclude a “disqualified person” from entering into a “prohibited transaction” with respect to a plan that is subject to the Code’s prohibited transaction rules.<sup>459</sup> A disqualified person includes a service provider for a plan, a fiduciary of a plan, and certain persons and entities that are related to service providers and fiduciaries.<sup>460</sup> A fiduciary of a plan is a person who: (1) exercises any discretionary authority or control with respect to the management of the plan or the management or disposition of plan assets; (2) renders investment advice for a direct or indirect fee with respect to property of the plan or has authority or responsibility to do so; or (3) has any discretionary authority or responsibility in

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<sup>458</sup> See James P. Baker, “How Much Is Too Much? A Primer on the 401(k) ‘Feegate’ Litigation,” *Benefits Law Journal*, Summer 2007.

<sup>459</sup> Sec. 4975. Plans sponsored by certain types of employers, such as a governmental plan, are not subject to the Code’s prohibited transaction rules. See sec. 4975(g). ERISA contains prohibited transaction rules that are generally parallel to the rules provided in the Code. See ERISA secs. 406 and 408.

<sup>460</sup> Sec. 4975(e)(2).



the administration of the plan.<sup>461</sup> Qualified retirement plans and section 403(a) employee retirement annuities are subject to the Code's prohibited transaction rules.<sup>462</sup> The Code's prohibited transaction rules also apply to certain plans to which ERISA does not apply, including IRAs.<sup>463</sup> The following types of transactions, whether direct or indirect, constitute prohibited transactions for purposes of the Code:

- Any sale, exchange, or leasing of any property between a plan and a disqualified person;
- Lending of money or extending credit by a plan to a disqualified person;
- Furnishing goods, services, or facilities by a plan to a disqualified person or by a disqualified person to a plan; and
- Any transfer to, or use by or for the benefit of, a disqualified person, of any assets of a plan.<sup>464</sup>

In addition to the foregoing prohibited transactions, the Code's prohibited transaction rules also limit the following transactions involving a plan fiduciary:

- Any act whereby the fiduciary deals with the income or assets of a plan in the fiduciary's own interest or for the fiduciary's own account; and
- Receipt of any consideration by the fiduciary for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.<sup>465</sup>

A two-tier tax is imposed under the Code on the disqualified person if a prohibited transaction occurs.<sup>466</sup> The initial tax applies during the correction period and is equal to 15 percent of the amount involved with respect to the prohibited transaction for each year or partial year in the "taxable period." The taxable period begins on the date that the prohibited transaction occurs and generally ends on the earlier of: (1) the date the transaction is corrected, or (2) the date notice of a deficiency with respect to the initial tax is mailed (or, if earlier, the

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<sup>461</sup> Sec. 4975(e)(3).

<sup>462</sup> Sec. 4975(e)(1). A qualified retirement plan and a section 403(a) employee retirement annuity may also be subject to ERISA's prohibited transaction rules. In addition, the ERISA rules may apply to plans that are not subject to the Code's prohibited transaction rules. For example, a section 403(b) tax-deferred annuity plan is not subject to the Code's prohibited transaction rules, but may be subject to ERISA's prohibited transaction rules. If a plan is subject to both the Code and ERISA prohibited transaction rules, the civil penalty specified in ERISA in the case of a violation of the rules is reduced by the amount of the excise taxes prescribed by the Code for such violation. ERISA sec. 502(l)(4).

<sup>463</sup> Sec. 4975(e)(1)(B) and (C).

<sup>464</sup> Sec. 4975(c)(1)(A) through (D).

<sup>465</sup> Sec. 4975(c)(1)(E) and (F).

<sup>466</sup> Sec. 4975(a) and (b).

date of assessment of such tax). If the prohibited transaction is not corrected within the taxable period, a second tax applies equal to 100 percent of the amount involved. Both taxes are paid by the disqualified person.

### Exemptions

The Code provides for statutory exceptions from the prohibited transaction rules.<sup>467</sup> In addition, the Secretary of Labor has authority to establish an exemption procedure for disqualified persons, or an exemption for transactions, if the exemption is: (1) administratively feasible, (2) in the interests of the plan, its participants and beneficiaries; and (3) protective of the rights of participants and beneficiaries of the plan.<sup>468</sup> These administrative exceptions take two forms: class exemptions, which are applicable to a class of disqualified persons or a class of transactions that meet the requirements specified in the terms of the class exemption; and individual exemptions, which are applicable solely to the transaction or disqualified person for which the exemption is issued. Administrative exemptions are subject to notice and comment (by publication of a proposed exemption in the Federal Register) prior to being granted.

Several exceptions to the prohibited transaction rules involve the provision of administrative or investment services by a disqualified person and are conditioned on the amount of the fee that is charged by the service provider. For example:

- A plan is permitted to contract or make reasonable arrangements with a disqualified person for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid.<sup>469</sup> Treasury regulations also provide that this exception applies to any service that is appropriate and helpful to the plan in carrying out the purposes for which the plan is established or maintained.<sup>470</sup> This exception does not apply to the prohibitions against fiduciary conflicts of interest (i.e., a fiduciary that deals with plan assets in his own interest or who receives consideration for his own personal account in connection with a plan transaction);<sup>471</sup>
- A bank (or other similar institution that is supervised by the United States or a State) may provide ancillary services to a plan subject to certain conditions, which include guidelines that prevent the bank from providing the services in an excessive or unreasonable manner and in a way inconsistent with the best interests of the plan's

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<sup>467</sup> Sec. 4975(d).

<sup>468</sup> Sec. 4975(c)(2) and sec. 102 of ERISA Reorganization Plan No. 4 of 1978, P.L. 99-514.

<sup>469</sup> Sec. 4975(d)(2).

<sup>470</sup> Treas. Reg. sec. 54.4975-6(a)(2).

<sup>471</sup> Treas. Reg. sec. 54.4975-6(a)(1). The prohibited transaction rules of ERISA specify that a plan fiduciary may receive reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his or her services for the plan. ERISA sec. 408(c)(2).

participants and beneficiaries. In addition, the plan must pay no more than reasonable compensation for the ancillary services;<sup>472</sup> and

- A plan fiduciary who is also an investment adviser to an open-end investment company is permitted to purchase or sell shares in the investment company on behalf of the plan if the plan does not pay a commission or an investment management fee with respect to the plan assets invested.<sup>473</sup>

### **Disclosure of plan fees to participants**

There is no provision under the Code that requires disclosure of plan fees to participants. ERISA, however, does require the disclosure of certain fee information to participants. For example, ERISA requires the administrator of a defined contribution plan to provide participants with an annual summary of certain information relating to the plan (referred to as the “summary annual report”).<sup>474</sup> Under regulations issued by the Department of Labor, the summary annual report must include the disclosure of the aggregate amount of administrative expenses paid by a plan for the year but is not otherwise required to separately state plan fees.<sup>475</sup> The administrators of both defined contribution and defined benefit retirement plans must periodically provide summary plan descriptions to plan participants (referred to as “SPDs”). SPDs are required to provide a description of any fees the payment of which is a condition for the receipt of plan benefits.<sup>476</sup>

In addition, participants in certain defined contribution plans may receive information regarding fees charged in connection with the investment of plan assets. This information is provided because ERISA offers relief from certain fiduciary requirements in the case of a plan that provides for participant-directed investment of plan assets, if certain requirements specified by the Secretary of Labor are satisfied.<sup>477</sup> Generally, this relief applies if a defined contribution plan permits a participant or beneficiary to exercise control over assets in his or her account, and that participant or beneficiary in fact exercises control over assets in the account.<sup>478</sup> The plan must provide the participant or beneficiary an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in the account are invested.<sup>479</sup>

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<sup>472</sup> Sec. 4975(d)(6).

<sup>473</sup> PTE 77-4, 42 Fed. Reg. 18732 (April 8, 1977).

<sup>474</sup> ERISA sec. 104(b)(3).

<sup>475</sup> 29 CFR sec. 2520.104b-10(d)(3).

<sup>476</sup> 29 CFR sec. 2520.102-3(l).

<sup>477</sup> ERISA sec. 404(c).

<sup>478</sup> 29 CFR sec. 2550.404c-1(a)(1).

<sup>479</sup> 29 CFR sec. 2550.404c-1(b)(1)(ii).

In order to satisfy the requirement that a participant or beneficiary be given an opportunity to exercise control over the assets in the account, the participant or beneficiary must be provided, or be given the opportunity to obtain, sufficient information to make informed decisions with regard to investment alternatives and incidents of ownership appurtenant to such investments.<sup>480</sup> This requirement to provide sufficient information includes the following required disclosures with respect to investment fees: (1) disclosure of any transaction fees and expenses which affect the participant's account balance in connection with purchases or sales of interests in the investment alternatives available under the plan, and (2) a description of the annual operating expenses of each designated investment alternative (e.g., investment management fees, administrative fees, transaction costs) which reduce the rate of return to plan participants and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative.<sup>481</sup>

### **Electronic delivery of employee benefit notices**

Treasury regulations provide standards by which a retirement plan, an employee benefit arrangement, or an individual retirement plan is permitted to use an electronic medium to provide notices required to be in writing.<sup>482</sup> For any requirement under the Code or regulations that an employee benefit notice or election be in writing or in written form, the standards in the regulations are generally the exclusive rules for providing such communication through the use of an electronic medium.<sup>483</sup> For any employee benefit notice that is not required to be in writing or in written form, the standards in the regulations are a safe harbor.

The Treasury regulations provide that an electronic system used to provide a notice must satisfy one of two alternative methods for providing notices electronically. Under one method there are two basic requirements. First, with respect to the content of the notice, the electronic system must be reasonably designed to provide the information to a recipient in a manner no less understandable to the recipient than if provided on a written paper document. Second, the electronic system must be reasonably designed to alert the recipient, at the time the notice is provided, to the significance of the information in the notice (including the identification of the subject matter of the notice), and provide any instructions needed to access the notice, in a manner that is as readily understandable and accessible as a notice provided using a written paper document. Under the other method, a notice generally is permitted to be provided to a recipient using an electronic medium after the recipient consents to the electronic delivery of the notice in a manner described in the regulations. This method is designed to reflect the provisions of the Electronic Signatures in Global and National Commerce Act, Pub.L.106-229, (generally referred to as E-SIGN).

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<sup>480</sup> 29 CFR sec. 2550.404c-1(b)(2)(i)(B).

<sup>481</sup> 29 CFR sec. 2550.404c-1(b)(2)(i)(B)(1)(v) and -1(b)(2)(i)(B)(2)(i).

<sup>482</sup> Treas. Reg. sec. 1.401(a)-21.

<sup>483</sup> The Treasury regulations do not apply to any notice, election, consent, disclosure, or obligation required under the provisions of title I or IV of ERISA over which the DOL or the PBGC has interpretative and enforcement authority.

Treasury regulations under section 4980F (enacted after E-SIGN) include certain rules regarding the electronic delivery of the required notice of an amendment to certain pension plans that either provides for a significant reduction in the rate of future benefit accrual or that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy (generally referred to as a “section 204(h) notice,” after the parallel notice requirements set forth in section 204(h) of ERISA).<sup>484</sup> These rules allow electronic delivery if: (1) either the notice is actually received by the applicable individual or the plan administrator takes appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice; and (2) the notice is delivered using an electronic medium (other than an oral communication or a recording of an oral communication) under an electronic system that satisfies the applicable notice requirements of Treasury Regulation section 1.401(a)-21.

The Labor regulations provide a standard under which the administrator of an employee benefit plan is permitted to furnish documents through electronic media.<sup>485</sup> The standard has some similarities to the Treasury regulations under section 4980F but differs in a number of ways. For example, the Labor regulations explicitly require that a plan administrator furnishing a document using electronic media take reasonable and necessary measures to ensure that the system protects the confidentiality of personal information relating to an individual’s accounts and benefit.

### **Description of Provision**

#### **Notice of Plan Fee Information to Plan Administrators**

The provision creates new section 4980J, which requires a service provider to provide certain fee-related information to the plan administrator<sup>486</sup> of an applicable defined contribution plan in: (1) an initial statement before entering into a new contract with the plan administrator; (2) an updated statement on an annual basis thereafter; and (3) an updated statement at any time during a plan year that an event or other change causes the information in any initial or annual statement to become materially incorrect.

#### **Applicable defined contribution plan**

An applicable defined contribution plan is any defined contribution plan that is a qualified trust, an annuity plan described in section 403(a), an annuity contract described in

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<sup>484</sup> Treas. Reg. sec. 54-4980F-1, A-13(c).

<sup>485</sup> 29 CFR sec. 2520.104b-1(c).

<sup>486</sup> The plan administrator is the person specifically designated as such by the plan instrument. In the absence of such designation, the plan administrator is the employer maintaining the plan or, in the case of a plan maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the plan administrator is the association, committee, joint board of trustees, or other similar group of representatives of the parties maintaining the plan. Sec. 414(g).

section 403(b), and an eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A).

### Service provider

A service provider is any person providing administration, recordkeeping, consulting, investment management services, or investment advice to an applicable defined contribution plan under a contract or arrangement, whether written or unwritten. The notice requirements apply to those service providers who contract directly with a plan administrator, therefore, they do not apply, for example, to persons with whom the service provider subcontracts to perform certain services specified in the contract or arrangement with the plan administrator. The service provider retains the responsibility for disclosing the fee information with respect to these subcontracted services. In these situations and other situations in which the service provider may be required to obtain and report information from a third party to meet its fee disclosure obligations, the service provider generally may rely on the accuracy of information provided by the third party, unless the service provider has reason to know the information is inaccurate or incomplete or has notice of facts or information that would prompt a reasonable service provider to inquire into the accuracy or completeness of the information.

For purposes of the new fee disclosure rules, all persons that would be treated as a single employer under subsection (b) or (c) of section 414 (if section 1563(a)(1) were applied by substituting ‘more than 50 percent’ for ‘at least 80 percent’ in each place it appears) are treated as a single service provider. Thus, where an applicable defined contribution plan contracts for services from two or more service providers who are members of the same controlled group, the initial, annual and material change statements must each be provided in a single coordinated statement reflecting the required information for the services provided by the controlled group as a single entity and not in a separate statement for each service provider.

The notice requirements do not apply to a contract or arrangement for services provided with respect to an applicable defined contribution plan for any plan year if the total expected annual revenue to be received by the service provider with respect to the plan for such plan year is expected to be less than \$5,000 and the service provider provides a written statement to the plan administrator that the total annual revenue expected to be received by the service provider with respect to the plan is less than that amount. Service providers that expect to receive de minimis annual revenue from the plan are exempt from the requirement to provide this written statement. The Secretary of Labor may, by regulation or other guidance, adjust the \$5,000 threshold.

### Initial statement of services provided and revenues received

Under the provision, prior to entering into any contract or arrangement to provide services to an applicable defined contribution plan, a service provider is required to provide the plan administrator with a single written statement that prominently discloses certain fee-related information with respect to the first plan year covered under the contract or arrangement. The disclosure requirements related to fees allocable to the management or investment of plan assets is therefore not met by the distribution to the plan administrator of a prospectus for each of the investment options offered under the plan. The initial statement is to be provided at such time

and in such manner as the Secretary of Labor may prescribe and the information included in the statement is required to be presented in a manner that is easily understood by the typical plan administrator.

The statement must include a detailed description of the services that the service provider will provide to the plan, the amount of total expected annual revenue (as defined below) with respect to those services, the manner in which the revenue will be collected, and the extent to which such revenue varies between specific investment options. In disclosing the manner in which the revenue will be collected, the service provider is required to disclose both the source of the payment and the formula under which the revenue is calculated.

The statement must separately detail the portion of total expected annual revenue that is properly allocable to each of the following: (1) administration and recordkeeping; (2) investment management; and (3) any other services or amounts. The entire amount of total expected annual revenue must be allocated among these categories and no amount may be taken into account under more than one category. The Secretary of Labor is otherwise directed to provide rules for defining total expected annual revenue and for the appropriate and consistent allocation of total expected annual revenue among these categories. In disclosing amounts that the service provider expects to receive, the service provider is required to provide a reasonable estimate of each of these amounts and must identify any estimated amount as such in the initial statement. Service providers are required to base any estimated amount on reasonable assumptions that are specified in the statement.

In providing information relating to fees, a service provider may express total expected annual revenue and the amount, if any, that the service provider expects to receive during the plan year in connection with plan administration, recordkeeping, consulting, management, or investment or other service activities undertaken with respect to the plan by any other person as a dollar amount, a percentage of assets, or a combination thereof, as appropriate. A service provider that chooses to present these amounts as a percentage of assets is required to properly allocate that percentage among each of the following sources of revenue: (1) administration and recordkeeping; (2) investment management; and (3) any other services or amounts.

A service provider must provide the identity of any investment option under the plan with respect to which the service provider (determined under the controlled group rule described above by substituting ‘at least 20 percent’ for ‘more than 50 percent’) provides substantial investment, trustee, custodial or administrative services and, with respect to any investment option under the plan, a statement as to whether the service provider expects to receive any component of total annual revenue in connection with any service activities (including plan administration, recordkeeping, consulting, management, or investment services) undertaken by any other person with respect to that option and the amount of any such component.

With respect to investment options with more than one share class or price level, the Secretary of Labor is directed to prescribe regulations for the disclosure of the different share classes or price levels available. These regulations are required to provide guidance with respect to the disclosure of the basis for qualifying for such share classes or price levels, which may include amounts invested, number of participants or other factors. To the extent provided in regulations issued by the Secretary of Labor, a service provider is required to separately disclose

the transaction costs (including sales commissions) for each investment option for the prior year or the plan's allocable share of such costs for the prior year.

A service provider who provides recordkeeping services with respect to any investment option is required to include such information as is necessary for the plan administrator to satisfy its advance, quarterly and material change disclosure obligations to plan participants and beneficiaries with respect to the investment options under the plan under new Code section 4980K (as described below). To the extent provided under regulations issued by the Secretary of Labor, this disclosure rule does not apply to a service provider if the service provider receives a written representation from the plan administrator that another service provider provides such information pursuant to a contract or arrangement to provide services to the plan.

For any plan year, "total expected annual revenue" means: (1) any amount expected to be received during the plan year from the plan (including amounts paid from participant accounts), or any participant or beneficiary or any plan sponsor in connection with the contract or arrangement; and (2) any amount not previously described that the service provider expects to receive during the plan year in connection with plan administration, recordkeeping, consulting, management, or investment or other service activities undertaken with respect to the plan by the service provider and by any other person. Fees and charges that a service provider expects to receive from participants or beneficiaries (or from the accounts of participants and beneficiaries) in connection with a participant-initiated transaction (other than loads, commissions, brokerage fees, and other investment-related transactions) are not taken into account in determining total expected annual revenue; however, the service provider is required to provide the plan administrator, as part of the required initial statement, with a separate fee schedule that describes each such fee or charge, the amount of each such fee or charge, and the manner in which the amount is collected.

#### Annual statements

With respect to each plan year after the plan year covered by the initial disclosure statement described above, a service provider is required to provide the plan administrator with a single written statement that includes updates of the information required to be provided in the initial statement. The annual statements are provided at such time and in such manner as the Secretary of Labor may prescribe.

#### Material change statements

In the case of any event or other change during a plan year which causes the information included in any initial or annual statement to become materially incorrect, the service provider is required to provide the plan administrator a written statement providing the corrected information not later than 30 days after the service provider knows, or exercising reasonable diligence would have known, of such event or other change.

#### Excise tax for failure to provide required notices

The provision imposes a tax on certain service providers who fail to provide any of the three required notices to the plan administrator. The tax is equal to \$1,000 per day for each day during the period beginning on the date the notice is required to be provided and ending on the



date that the notice is provided or the failure is otherwise corrected. The total amount of tax that may be imposed on a service provider with respect to an applicable defined contribution plan for a plan year may not exceed the lesser of: (1) 10 percent of the assets of the plan (determined as of the first day of the plan year); or (2) \$1,000,000. No tax is imposed with respect to any failure if the service provider exercised reasonable diligence to meet the notice requirement to which the failure relates and the required notice is provided during the 30-day period beginning on the date the service provider knew, or exercising reasonable diligence would have known, that the failure existed. The Secretary of the Treasury may waive all or part of the tax in the case of a failure which is due to reasonable cause and not to willful neglect, if the payment of the tax would be excessive or otherwise inequitable to the failure involved.<sup>487</sup>

### **Required notice to participants of plan fee information**

The provision creates new section 4980K, which requires a plan administrator of an applicable defined contributions plan to provide notices to participants regarding plan fees. First, a notice detailing the investment options available under the plan must be given to participants prior to the earliest date on which the initial investment of any contribution to the account can be made. Similar notice must also be given before the effective date of any change in the list of investment options under the plan (or as soon as practicable if advance notice is impracticable). Second, at least once each quarter, the plan administrator must provide each participant and beneficiary with a benefit statement describing the investment options in which the participant's or beneficiary's account balance is invested (as of the last day of the preceding quarter). In the case of a plan that has fewer than 100 participants and beneficiaries as of the first day of the plan year, the benefit statement may be provided on an annual rather than a quarterly basis.

The provision specifies the information that must be included in each notice and provides that all information be presented in a manner that is easily understood by the typical plan participant. The required notices are to be provided at such time, and in such manner, as the Secretary of Labor may prescribe.

### **Applicable defined contribution plan**

An applicable defined contribution plan is the portion of an eligible employer plan that is a defined contribution plan and which permits a participant to exercise control over assets in his or her account. An eligible employer plan is a qualified trust, a section 403(a) annuity plan, a section 403(b) plan, and a governmental section 457(b) plan.<sup>488</sup> Thus, the provision does not apply to IRAs.

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<sup>487</sup> The provision also imposes requirements, and penalties, under ERISA. The penalty imposed under ERISA with respect to any failure is reduced by the amount of tax imposed on a service provider under section 4980J.

<sup>488</sup> A governmental section 457(b) plan is an eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A).

## Advance notice of available investment options

### Required information

With respect to each available option, the advance notice of available investment options must provide the following information: (1) the name of the option; (2) a general description of the option's investment objectives and principal investment strategies, principal risk and return characteristics, and the name of the option's investment manager; (3) whether the option is designed to be a comprehensive, standalone investment for retirement that provides varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures; (4) the extent to which the investment option is actively managed or passively managed (or a combination of both) in relation to an index; and (5) where, and the manner in which, additional plan-specific, option-specific, and generally available investment information may be obtained. The notice must also provide additional general information for use by the participant in evaluating the investment choices, including an explanation of the difference between active and passive management. Further, the notice must explain that investment options should not be evaluated solely on the basis of the charges for each option but should also be based on careful consideration of other key factors, including the option's risk level, investment objectives, and historical returns, and the participant's personal investment objectives.

### Plan fee comparison chart

With respect to the manner of presenting the required information, the notice must include a plan fee comparison chart which provides a comparison of the service and investment charges that will or could be assessed against the account of the participant or beneficiary for the plan year. The charges can be provided in the form of a dollar amount or a formula (such as a percentage of assets), as appropriate. The plan fee comparison chart must provide information regarding to the following categories of charges: asset-based charges specific to an investment, asset based charges not specific to an investment, administrative and transaction based charges, and other charges.

Asset based charges specific to an investment are charges that vary depending on the investment options selected by the participant or beneficiary, including the annual operating expenses of the investment option and loads, commissions, brokerage fees, exchange fees, account fees, redemption fees, and surrender charges. The information relating to asset based charges specific to an investment must include a statement noting any charges for one or more investment options which pay for services other than investment management, except as otherwise provided in regulations.

Asset based charges not specific to an investment are charges that are assessed as a percentage of the total assets in the account of the participant or beneficiary, regardless of the investment option selected.

Administrative and transaction-based charges include fees charged to participants to cover plan administration, compliance, and recordkeeping costs, plan loan origination fees, possible redemption fees, and possible surrender charges, that are not assessed as a percentage of

the total assets in the account and are either automatically deducted each year or result from certain transactions engaged in by the participant or beneficiary.

The chart must also include any other charges which may be deducted from participants' or beneficiaries' accounts and which are not included in the categories described above.

Finally, the plan fee comparison chart must include, with respect to each investment option, the historical returns (net of fees and expenses) for the previous year, five years, and ten years (or for the period since inception, if shorter), and the historical returns of an appropriate benchmark, index, or other point of comparison for each such period.

#### Service provider notice available upon request

The advance notice of available investment options must also include an explanation of the participant's right to request, and to receive, a copy of the statements received by the plan administrator with respect to the plan from the service provider, including the plan fee comparison chart. The plan administrator must provide to any participant or beneficiary a copy of any such statement within 30 days of any request for such statement.

#### Use of estimates in the investment option notice

For purposes of the advance notice of available investment options, the plan administrator is permitted to provide a reasonable and representative estimate for any charges or percentages disclosed under the notice, including the comparison chart, but must indicate when an estimate is used.

#### Notice of material changes

In the case of any event or other change during a plan year which causes the information included in the advance notice of available investment options to become materially incorrect, the plan administrator is required to provide participants and beneficiaries a written statement providing the corrected information not later than 30 days after the plan administrator knows, or exercising reasonable diligence would have known, of such event or other change.

#### Quarterly benefit statement

The plan administrator must provide to each participant and beneficiary, at least once each calendar quarter, an explanation describing the investment options in which the participant's or beneficiary's account is invested as of the last day of the preceding quarter. The explanation must provide a description, to the extent applicable, of the following for the preceding quarter: (1) as of the last day of the quarter, the different asset classes that the participant's or beneficiary's account is invested in and the percentage of the account allocated to each asset class; (2) a statement of the starting and ending balance of the participant's or beneficiary's account for such quarter; (3) a statement of the total contributions or restorative payments made to the participant's or beneficiary's account during the quarter and a separate statement of the amount of such contributions, and the total restorative payments, that were made by the employer, and the amount of such contributions that were made by the employee; (4) a statement of the total fees and expenses that were directly deducted from the participant's or

beneficiary's account during the quarter and an itemization of such fees and expenses; and (5) a statement of the net returns for the year to date as expressed as a percentage and a statement as to whether the net returns include amounts described in the statement of total fees and expenses (described in (4)).

With respect to each investment option in which the participant or beneficiary was invested as of the last day of the quarter, the statement must include the following information: (1) the percentage of the participant's or beneficiary's account that is invested in such option as of the last day of such quarter; (2) the starting and ending balance of the participant's or beneficiary's account that is invested in such option for such quarter; (3) the annual operating expenses of the investment option; (4) a statement regarding how a participant or beneficiary may access the information required to be disclosed under investment option notice.

Annual operating expenses disclosed in the benefit statement may be expressed as a dollar amount or as a percentage of assets (or a combination of both). The plan administrator may disclose the actual annual operating expenses for the quarter or may provide a reasonable and representative estimate of such expenses. The benefit statement must state when an estimate is being provided. Any such estimate must be based on reasonable assumptions and the assumptions must be stated together with such estimate. To the extent that estimated expenses are expressed as a percentage of assets, the benefit statement must also include one of the following, stated in dollar amounts: (1) an estimate of the expenses or the quarter based on the amount invested in the option; or (2) an example describing the expenses that would apply during the quarter with respect to a hypothetical \$10,000 investment in the option.

The quarterly benefit statement must also explain that investment options should not be evaluated solely on the basis of the charges for each option but should also be based on careful consideration of other key factors, including the option's risk level, investment objectives, and historical returns, and the participant's personal investment objectives.

#### Model notices

The Secretary of Labor is directed to prescribe one or more model notices that may be used for purposes of satisfying the requirement to provide both the advance notice of available investment options, including model plan fee comparison charts, and the quarterly benefit statements.

#### Delegation of regulatory authority

The Secretary of Labor is directed to prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of these notice requirements, including regulations or other guidance which provide a later deadline for providing the notice of investment menu changes in appropriate circumstances, and provide guidelines, and a safe harbor, for the selection of an appropriate benchmark, index, or other points of comparison for an investment option.

### Excise tax for failure to provide any required participant notice

A tax is imposed on the plan administrator of an applicable defined contribution plan for each failure to provide any of the three required notices: the advance notice of available investment options, the quarterly statement, or the service provider notice (if requested by a participant or beneficiary). The amount of tax imposed for any failure with respect to any participant or beneficiary is \$100 for each day in the noncompliance period. The noncompliance period with respect to the failure to provide any investment option notice account statement, or service provider notice with respect to any participant or beneficiary is the period beginning on the date that such notice, explanation, or statement was required to be provided and ending on the date that such notice, explanation, or statement is provided or the failure is otherwise corrected. The total amount of tax imposed with respect to any plan for any plan year must not exceed an amount equal to the lesser of: (1) 10 percent of the assets of the plan, determined as of the first day of such plan year; or (2) \$500,000.

No tax is imposed on any failure if the plan administrator exercised reasonable diligence to meet the notice requirements, and the notice, explanation, or statement to which the failure relates is provided during the 30-day period beginning on the date the employer or plan knew, or exercising reasonable diligence would have known, that such failure existed. In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary will waive part or all of the tax imposed by subsection to the extent that the payment of such tax would be excessive or otherwise inequitable relative to the failure involved.<sup>489</sup>

### **Regulatory Authority and Coordination**

The Secretary of Labor is directed to prescribe regulations and other guidance to the extent that the Secretary determines necessary or appropriate to carry out the purposes of new sections 4980J and 4980K, including regulations or other guidance that: (1) provide safe harbor and simplified methods for allocating total expected annual revenues; (2) provide special rules for the application of that section to investments with a guaranteed rate of return, investments with an insurance component and employer sponsored retirement plans funded through an individual retirement account; (3) address notices with respect to investments provided through participant-directed brokerage trading; (4) address the disclosure of information that is not proprietary to the service provider for example (if an investment option is not managed by the service provider); and (5) provide rules to allow a service provider to consolidate information from other service providers that will satisfy the requirements of such sections with respect to all such service providers.

The provision directs the Secretary of Treasury and the Secretary of Labor to execute an interagency memorandum of understanding to ensure that coordination of policies related to enforcing the same requirements through such Secretaries in order to have a coordinated enforcement strategy that avoids duplication of enforcement efforts and assigns priorities in enforcement.

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<sup>489</sup> The provision also imposes requirements, and penalties, under ERISA. The penalty imposed under ERISA with respect to any failure is reduced by the amount of tax imposed under section 4980K.

Any disclosure to participants required under new section 4980K may be provided through an electronic medium under such rules as must be prescribed by the Secretary of Labor not later than one year after the date of the enactment of the bill. Such rules are directed to be similar to those applicable under the Code with respect to notices to participants in pension plans. Such Secretary is directed to regularly modify such rules as appropriate to take into account new developments, including new forms of electronic media, and to fairly take into consideration the interests of plan sponsors, service providers, and participants. The rules must provide for a method for the typical participant or beneficiary to obtain without undue burden any such disclosure in writing on paper in lieu of receipt through an electronic medium.

#### **Effective Date**

The provision applies to plan years beginning after December 31, 2011. Under the provision, for purposes of new Code section 4980J, any contract or arrangement to provide services to a plan which is in effect on January 1, 2012 is treated as a new contract or arrangement entered into on that date.

Until 12 months following the Department of Labor's issuance of final regulations under the provision, a service provider or plan administrator is treated as having complied with the requirements of the provision if such service provider or plan administrator complies with a good faith interpretation of such requirements.

## **TITLE IV – REVENUE OFFSETS**

### **A. Foreign Provisions**

#### **1. Rules to prevent splitting foreign tax credits from the income to which they relate (sec. 401 of the bill and new sec. 909 of the Code)**

##### **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; the foreign tax credit provides relief from double taxation. Subject to the limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays or accrues. 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 by the foreign corporation that the domestic corporation is deemed to have paid when the foreign corporation's earnings are distributed or included in the domestic corporation's income under the provisions of subpart F.<sup>490</sup>

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.<sup>491</sup> 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.

The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>492</sup>

##### **Deemed-paid foreign tax credit**

Domestic corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder.<sup>493</sup> This credit is the deemed-paid or indirect foreign tax credit. A domestic corporation may also be deemed to have paid taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.<sup>494</sup> Foreign taxes paid below the third tier are eligible for the deemed-paid credit only

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<sup>490</sup> Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

<sup>491</sup> Secs. 901(b), 903.

<sup>492</sup> Sec. 164(a)(3).

<sup>493</sup> Sec. 902(a).

<sup>494</sup> Sec. 902(b).

with respect to taxes paid in taxable years during which the payor is a controlled foreign corporation (“CFC”). Foreign taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to subpart F inclusions and inclusions under the PFIC provisions.<sup>495</sup>

The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be “grossed-up”) and is included in the domestic corporate shareholder’s income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation.<sup>496</sup>

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation’s accumulated earnings and profits.<sup>497</sup> Accumulated earnings and profits for this purpose include the earnings and profits of the current year undiminished by the current distribution (or other inclusion).<sup>498</sup> Dividends in excess of the pool of post-1986 undistributed earnings and profits are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.<sup>499</sup>

### **Foreign tax credit limitation**

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).<sup>500</sup> 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.<sup>501</sup>

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<sup>495</sup> Secs. 960(a), 1291(g), 1293(f).

<sup>496</sup> Sec. 78.

<sup>497</sup> Sec. 902(c)(6)(B). Earnings and profits computations for these purposes are to be made under U.S. concepts. Secs. 902(c)(1), 964(a).

<sup>498</sup> Sec. 902(c)(1).

<sup>499</sup> Sec. 902(c)(6).

<sup>500</sup> Secs. 901, 904.

<sup>501</sup> Sec. 904(c).



The foreign tax credit limitation is generally applied separately for income in two different categories (referred to as “baskets”), passive basket income and general basket income.<sup>502</sup> Passive basket income generally includes investment income such as dividends, interest, rents, and royalties.<sup>503</sup> General basket income is all income that is not in the passive basket. 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 basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).<sup>504</sup> Passive income is also treated as general basket 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).<sup>505</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least 10 percent of the CFC are assigned to a separate limitation basket by reference to the basket of income out of which the dividend or other payment is made.<sup>506</sup> Dividends received by a 10-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>507</sup>

### **Explanation of Provision**

The provision adopts a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. In general, the provision states that when there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by the taxpayer, such tax is not taken into account for purposes of the Code before the taxable year in which the related income is taken into account by the taxpayer under chapter 1 of the Code. In addition, if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a section 902 corporation, that tax is not taken into account for purposes of section 902 or 960, or for purposes of determining earnings and profits under section 964(a), before the taxable year in which the related income is taken into account under chapter 1 of the Code by the section 902

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<sup>502</sup> 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(h)(10), 865(h).

<sup>503</sup> 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.

<sup>504</sup> Sec. 904(d)(2)(C), (D).

<sup>505</sup> Sec. 904(d)(2)(F).

<sup>506</sup> Sec. 904(d)(3).

<sup>507</sup> Sec. 904(d)(4).

corporation, or a domestic corporation that meets the ownership requirements of section 902(a) or (b) with respect to the section 902 corporation. Thus, such tax is not added to the section 902 corporation's foreign tax pool, and its earnings and profits are not reduced by such tax.

In the case of a partnership, the provision's matching rule is applied at the partner level, and, except as otherwise provided by the Secretary, a similar rule applies in the case of any S corporation or trust. The Secretary may also issue regulations to establish the applicability of this matching rule to a regulated investment company that elects under section 853 for the foreign income taxes it pays to be treated as creditable to its shareholders under section 901.

For purposes of the provision, there is a "foreign tax credit splitting event" with respect to a foreign income tax if the related income is (or will be) taken into account under chapter 1 of the Code by a covered person.<sup>508</sup> A "foreign income tax" is any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States. This term includes any tax paid in lieu of such a tax within the meaning of section 903. "Related income" means, with respect to any portion of any foreign income tax, the income (or, as appropriate, earnings and profits), calculated under U.S. tax principles, to which such portion of foreign income tax relates. For purposes of determining related income, the Secretary may provide rules on the treatment of losses, deficits in earnings and profits, and certain timing differences between U.S. and foreign tax law.

With respect to any person who pays or accrues a foreign income tax (hereafter referred to in this paragraph as the "payor"), a "covered person" is: (1) any entity in which the payor holds, directly or indirectly, at least a 10-percent ownership interest (determined by vote or value); (2) any person that holds, directly or indirectly, at least a 10-percent ownership interest (determined by vote or value) in the payor; (3) any person that bears a relationship to the payor described in section 267(b) or 707(b) (including by application of the constructive ownership rules of section 267(c)); and (4) any other person specified by the Secretary. Accordingly, the Secretary may issue regulations that treat an unrelated counterparty as a covered person in certain sale-repurchase transactions and certain other transactions deemed abusive.

A "section 902 corporation" is any foreign corporation with respect to which one or more domestic corporations meets the ownership requirements of section 902(a) or (b).

Except as otherwise provided by the Secretary, in the case of any foreign income tax not currently taken into account by reason of the provision's matching rule, such tax is taken into account as a foreign income tax paid or accrued in the taxable year in which, and to the extent that, the taxpayer, the section 902 corporation, or a domestic corporation that meets the ownership requirements of section 902(a) or (b) with respect to the section 902 corporation (as the case may be) takes the related income into account under chapter 1 of the Code. Accordingly, for purposes of determining the carryback and carryover of excess foreign tax

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<sup>508</sup> It is not intended that there be a foreign tax credit splitting event when, for example, a CFC pays or accrues a foreign income tax and takes into account the related income in the same year, even though the earnings and profits to which the foreign income tax relates may be distributed to a covered person as a dividend or included in such covered person's income under subpart F.

credits under section 904(c), the deduction for foreign taxes paid or accrued under section 164(a), and the extended period for claim of a credit or refund under section 6511(d)(3)(A), foreign income taxes to which the provision applies will first be taken into account, and treated as paid or accrued, in the year in which the related foreign income is taken into account. Notwithstanding the preceding rule, foreign taxes are translated into U.S. dollars in the year in which the taxes are paid or accrued under the general rules of section 986 rather than the year in which the related income is taken into account. The Secretary may issue regulations or other guidance providing additional exceptions.

The Secretary is also granted authority to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of the provision. Such guidance may include providing successor rules addressing circumstances such as where, with respect to a foreign tax credit splitting event, the person who pays or accrues the foreign income tax or any covered person is liquidated. This grant of authority also allows the Secretary to provide appropriate exceptions from the application of the provision as well as to provide guidance as to how the provision applies in the case of any foreign tax credit splitting event involving a hybrid instrument. It is anticipated that the Secretary may also provide guidance as to the proper application of the provision in cases involving disregarded payments or other arrangements having a similar effect.

An example of a foreign tax credit splitting event involving a hybrid instrument subject to the provision is as follows. U.S. Corp., a domestic corporation, wholly owns CFC1, a country A corporation. CFC1, in turn, wholly owns CFC2, a country A corporation. CFC2 is engaged in an active business that generates \$100 of income. CFC2 issues a hybrid instrument to CFC1. This instrument is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. Under the terms of the hybrid instrument, CFC2 accrues (but does not pay currently) interest to CFC1 equal to \$100. As a result, CFC2 has no income for country A tax purposes, while CFC1 has \$100 of income, which is subject to country A tax at a 30 percent rate. For U.S. tax purposes, CFC2 still has \$100 of earnings and profits (the accrued interest is ignored since the United States views the hybrid instrument as equity), while CFC1 has paid \$30 of foreign taxes. Under the provision, the related income with respect to the \$30 of foreign taxes paid by CFC1 is the \$100 of earnings and profits of CFC2.

### **Effective Date**

In general, the provision is effective with respect to foreign income taxes paid or accrued by U.S. taxpayers and section 902 corporations after May 20, 2010.

The provision also applies to foreign income taxes paid or accrued by a section 902 corporation on or before May 20, 2010 (and not deemed paid under section 902(a) or 960 on or before such date), but only for purposes of applying sections 902 and 960 with respect to periods after such date (the “deemed-paid transition rule”). Accordingly, such rule applies for purposes of applying section 902 and 960 to dividends paid, and inclusions under section 951(a) that occur, after May 20, 2010. However, no adjustment is made to a section 902 corporation’s earnings and profits for the amount of any foreign income taxes suspended under the deemed-paid transition rule, either at the time of suspension or when such taxes are subsequently taken into account under the provision.

## **2. Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions (sec. 402 of the bill and new sec. 901(m) of the Code)**

### **Present Law**

#### **Foreign tax credit**

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; the foreign tax credit provides relief from double taxation. Subject to the limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. 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 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.<sup>509</sup>

The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>510</sup>

#### **Deemed-paid foreign tax credit**

U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation’s E&P become subject to U.S. tax as dividend income of the U.S. shareholder.<sup>511</sup> This credit is the “deemed-paid” or “indirect” foreign tax credit. A U.S. corporation may also be deemed to have paid foreign income taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.<sup>512</sup> Foreign income taxes paid below the third tier are eligible for the deemed-paid credit only with respect to foreign income taxes paid in taxable years during which the payor is a controlled foreign corporation (“CFC”). Foreign income taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to subpart F inclusions.<sup>513</sup> Moreover, a deemed-paid credit generally is available with respect to

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<sup>509</sup> Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company (“PFIC”) rules.

<sup>510</sup> Sec. 164(a)(3).

<sup>511</sup> Sec. 902(a).

<sup>512</sup> Sec. 902(b).

<sup>513</sup> Sec. 960(a).

inclusions under the PFIC provisions by U.S. corporations meeting the requisite ownership threshold.<sup>514</sup>

The amount of foreign income tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be “grossed-up”) and is included in the U.S. corporate shareholder’s income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign income tax paid by the foreign corporation.<sup>515</sup>

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation’s accumulated E&P.<sup>516</sup> Accumulated E&P for this purpose include the E&P of the current year undiminished by the current distribution (or other inclusion).<sup>517</sup> Dividends in excess of the accumulated pool of post-1986 undistributed E&P are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.<sup>518</sup>

#### Foreign tax credit limitation

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).<sup>519</sup> 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 the excess back to the previous taxable year or forward to one of the succeeding 10 taxable years.<sup>520</sup>

The foreign tax credit limitation is generally applied separately to two different categories of income (referred to as “baskets”), passive basket income and general basket income.<sup>521</sup>

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<sup>514</sup> Secs. 1291(g), 1293(f).

<sup>515</sup> Sec. 78.

<sup>516</sup> Sec. 902(c)(6)(B). Earnings and profits computations for these purposes are to be made under U.S. concepts. Secs. 902(c)(1), 964(a).

<sup>517</sup> Sec. 902(c)(1).

<sup>518</sup> Sec. 902(c)(6).

<sup>519</sup> Secs. 901, 904.

<sup>520</sup> Sec. 904(c).

<sup>521</sup> 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(h)(10), 865(h).

Passive basket income generally includes investment income such as dividends, interest, rents, and royalties.<sup>522</sup> General basket 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, foreign tax imposed on income in one basket cannot be claimed as a credit against U.S. tax on income in the other basket.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).<sup>523</sup> Passive income is also treated as general basket 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).<sup>524</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least 10 percent of the CFC are assigned to a separate limitation basket by reference to the basket of income out of which the dividend or other payment is made.<sup>525</sup> Dividends received by a 10-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>526</sup>

### **Items giving rise to permanent basis differences**

In general, certain elections or transactions can result in the creation of additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the basis of such assets for foreign tax purposes. These include: (1) a qualifying stock purchase of a foreign corporation or domestic corporation with foreign assets for which a section 338 election is made; (2) an acquisition of an interest in a partnership holding foreign assets for which a section 754 election is in effect; and (3) certain other transactions involving an entity classification (“check-the-box”) election in which a foreign entity is treated as a corporation for foreign tax purposes and as a partnership or disregarded entity for U.S. tax purposes.<sup>527</sup>

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<sup>522</sup> 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.

<sup>523</sup> Sec. 904(d)(2)(C), (D).

<sup>524</sup> Sec. 904(d)(2)(F).

<sup>525</sup> Sec. 904(d)(3).

<sup>526</sup> Sec. 904(d)(4).

<sup>527</sup> Treas. Reg. sec. 301.7701-1, *et seq.*

### Section 338 elections

In general, the basis of stock acquired by a U.S. taxpayer or a foreign subsidiary of a U.S. taxpayer is its cost,<sup>528</sup> and there is no adjustment to the basis of the assets held by the acquired corporation.<sup>529</sup> In certain circumstances, however, taxpayers may elect to treat a qualifying purchase of 80 percent of the stock of a target corporation (a “qualified stock purchase”) as a purchase of the underlying assets of the target corporation.<sup>530</sup> For this purpose, a “qualified stock purchase” is any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of one corporation is acquired by another corporation by purchase during the 12-month acquisition period.<sup>531</sup>

Two alternatives exist for making a section 338 election when there is a qualifying stock purchase—one bilateral and one unilateral. A bilateral election, which is made pursuant to section 338(h)(10), requires a corporation to make a qualifying purchase of 80 percent of the stock of a domestic target corporation<sup>532</sup> that is a member of a selling consolidated group (or affiliated group if no election to file a consolidated return has been made), or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders. The election is made jointly by the buyer and seller of the stock and must be made by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. Pursuant to this election, the assets (rather than the stock) of the target corporation are deemed to have been sold in a single transaction at the close of the acquisition date, and the target corporation is deemed to have liquidated. The asset sale is taken into account by the target prior to its acquisition by the purchasing corporation.<sup>533</sup>

With a unilateral election, which is made pursuant to section 338(g), the purchasing corporation treats a qualified stock purchase of a corporation (including a foreign corporation) as a deemed asset acquisition, whether or not the seller of the stock is a corporation. Pursuant to this election, the seller or sellers recognize gain or loss on the stock sale, and the target corporation also recognizes gain or loss on the deemed asset sale. The deemed asset acquisition

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<sup>528</sup> Secs. 1011, 1012.

<sup>529</sup> See sec. 1016.

<sup>530</sup> Sec. 338(a).

<sup>531</sup> Sec. 338(d)(3). Under section 1504(a)(2), the ownership of stock of any corporation meets the requirements of an affiliated group if it (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and (B) has a value equal to at least 80 percent of the total value of the stock of such corporation. Further, section 1504(a)(4) states that for purposes of meeting the 80-percent requirement, the term stock does not include any stock which (A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which do not exceed the issue price of such stock, and (D) is not convertible into another class of stock.

<sup>532</sup> A foreign corporation cannot be the target corporation in the case of a section 338(h)(10) election. See Treas. Reg. sec. 1.338(h)(10)-1(b)(1), (2), (3).

<sup>533</sup> Sec. 338(h)(10); Treas. Regs. sec. 1.338(h)(10)-1(d)(3).

also eliminates the historic E&P of the target corporation. In general, in cases in which the target corporation is foreign and the seller is a U.S. person or a CFC, the deemed asset sale has U.S. tax consequences.<sup>534</sup> However, when the seller is neither a U.S. person nor a CFC, generally no U.S. tax consequences result from the deemed asset sale.<sup>535</sup> The election is made by the purchasing corporation and must be made by the 15th day of the ninth month beginning after the month in which the acquisition date occurs.

Pursuant to a section 338 election, the target corporation is treated as (1) having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and (2) a new corporation that purchased all of the assets as of the beginning of the day after the acquisition date.<sup>536</sup> Accordingly, the aggregate basis of the assets of the target equals the sum of (1) the grossed-up basis of the purchasing corporation's recently purchased stock, and (2) the basis of the purchasing corporation's nonrecently purchased stock, with appropriate adjustments for liabilities and other relevant items under the regulations.<sup>537</sup>

Since a section 338 election is relevant solely for U.S. tax purposes, the adjustment to the basis of the assets of a foreign target corporation (or a foreign branch of a domestic corporation) that increases the amount of depreciation, amortization, depletion, or gain for purposes of calculating U.S. taxable income or E&P results in no corresponding adjustment for foreign income tax purposes. As a result, cost recovery deductions attributable to such additional basis generally result in a permanent difference between (1) the foreign taxable income upon which foreign income tax is levied, and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed for any foreign income taxes paid.

#### Section 754 election

A partnership does not generally adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 for such purposes.<sup>538</sup> If an election is in effect, adjustments to the basis of

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<sup>534</sup> Section 338(h)(16) addresses the impact of the deemed asset sale on the E&P of the foreign target corporation for purposes of determining the source and character of any amount includible in gross income as a dividend under section 1248 to the seller.

<sup>535</sup> When a domestic corporation or a CFC is the purchaser with respect to which a section 338(g) election is made for a foreign target corporation, the deemed asset sale may have U.S. tax consequences. For example, if the foreign target becomes a CFC for an uninterrupted period of 30 days or more during a taxable year pursuant to Section 951(a) prior to the purchasing corporation completing the qualified stock purchase, the deemed asset sale may generate subpart F income for any U.S. shareholder of the foreign target corporation. Treas. Reg. sec. 1.338-9(b).

<sup>536</sup> Sec. 338(a).

<sup>537</sup> Sec. 338(b).

<sup>538</sup> Sec. 743(a). But see section 743(d) requiring a reduction to the basis of partnership property in certain cases where there is a substantial built-in loss.



partnership property are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.<sup>539</sup> These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Since a section 754 election has relevance only for U.S. tax purposes, to the extent that the underlying assets of the partnership include assets generating income subject to foreign tax, the basis adjustments made to these assets may also result in permanent differences between (1) the foreign taxable income upon which foreign income tax is levied, and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed for any foreign income taxes paid.

#### Check-the-box election

Comparable permanent differences between foreign taxable income and U.S. taxable income (or E&P) may also be achieved as a result of making a check-the-box election. Since a check-the-box election generally has no effect for foreign tax purposes, a sale of a wholly-owned foreign corporation for which an election to be disregarded is in effect will be respected as the sale of the corporation for foreign tax purposes but treated as the sale of branch assets for U.S. tax purposes. If the purchaser is a U.S. taxpayer or a foreign entity owned by a U.S. taxpayer, the U.S. taxpayer may have additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the tax basis of such assets for foreign tax purposes. In this case, there would be a permanent difference between (1) the foreign taxable income upon which foreign income tax is levied, and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed. Similar results may be achieved through other transactions in which a check-the-box election has been made.

#### Explanation of Provision

The provision denies a credit for the disqualified portion of any foreign income tax paid or accrued in connection with a covered asset acquisition.

A "covered asset acquisition" means: (1) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies;<sup>540</sup> (2) any transaction that is treated as the acquisition of assets for U.S. tax purposes and as the acquisition of stock (or is disregarded)<sup>541</sup> for purposes of the foreign income taxes of the relevant jurisdiction;<sup>542</sup> (3) any acquisition of an

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<sup>539</sup> Sec. 743(b).

<sup>540</sup> This includes transaction under section 338(g) and section 338(h)(10).

<sup>541</sup> For example, the deemed liquidation of a CFC as the result of the making of an entity classification election pursuant to Treas. Reg. sec. 301.7701-3 may result in a section 331 liquidation for U.S. tax purposes that is disregarded for foreign income tax purposes.

<sup>542</sup> Section 336(e) provides that, to the extent provided by the Secretary, in cases in which (1) a corporation owns at least 80 percent of the vote and value of stock of another corporation (as defined in section 1504(a)(2)), and

interest in a partnership that has an election in effect under section 754; and (4) to the extent provided by the Secretary, any other similar transaction. It is anticipated that the Secretary will issue regulations identifying other similar transactions that result in an increase to the basis of assets for U.S. tax purposes without a corresponding increase for foreign tax purposes.

The disqualified portion of any foreign income taxes paid or accrued with respect to any covered asset acquisition, for any taxable year, is the ratio (expressed as a percentage) of (1) the aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets, divided by (2) the income on which the foreign income tax is determined. For this purpose, the income on which the foreign income tax is determined is the income as determined under the law of the relevant jurisdiction. If the taxpayer fails to substantiate such income to the satisfaction of the Secretary, then such income is determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction.

For purposes of determining the aggregate basis difference allocable to a taxable year, the term “basis difference” means, with respect to any relevant foreign asset, the excess of (1) the adjusted basis of such asset immediately after the covered asset acquisition, over (2) the adjusted basis of such asset immediately before the covered asset acquisition. Thus, it is the tax basis for U.S. tax purposes that is relevant, and not the basis as determined under the law of the relevant jurisdiction. Because CFCs are generally limited to straight-line cost recovery, it is anticipated that the basis difference applying U.S. tax principles will generally be less than if the taxpayer were required to use the basis as determined under foreign law immediately before the covered asset acquisition. However, it is anticipated that the Secretary will issue regulations identifying those circumstances in which, for purposes of determining the adjusted basis of such assets immediately before the covered asset acquisition, it may be acceptable to utilize the basis of such asset under the law of the relevant jurisdiction or another reasonable method.

A built-in loss in a relevant foreign asset (i.e., in cases in which the fair market value of the asset is less than its adjusted basis immediately before the asset acquisition) is taken into account in determining the aggregate basis difference; however, a built-in loss cannot reduce the aggregate basis difference allocable to a taxable year below zero.

In the case of a qualified stock purchase to which section 338(a) applies, the covered asset acquisition is treated as occurring at the close of the acquisition date (as defined in section 338(h)(2)).

In general, the amount of the basis difference allocable to a taxable year with respect to any relevant foreign asset is determined using the applicable cost recovery method under U.S.

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(2) such corporation sells, exchanges, or distributes all of stock of such corporation, an election may be made to treat this sale, exchange, or distribution as a disposition of all of the assets of the other corporation, and no gain or loss is recognized on the sale, exchange, or distribution of the stock. To date, the Secretary has not promulgated regulations under section 336(e) so no election may be made. Nonetheless, to the extent regulations are promulgated under section 336(e) in the future permitting such an election to be made, a transaction to which the section 336(e) election relates would be a covered asset acquisition.

tax rules. If there is a disposition of any relevant foreign asset before its cost has been entirely recovered or of any relevant foreign asset that is not eligible for cost recovery (e.g., land), the basis difference allocated to the taxable year of the disposition is the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset that has been allocated under this provision to all prior taxable years. Thus, any remaining basis difference is captured in the year of the sale, and there is no remaining basis difference to be allocated to any subsequent tax years. However, it is intended that this provision generally apply in circumstances in which there is a disposition of a relevant foreign asset where the associated income or gain is taken into account for purposes of determining foreign income tax in the relevant jurisdiction.

To illustrate, assume USP, a domestic corporation, acquires 100 percent of the stock of FT, a foreign target organized in Country F with a “u” functional currency, in a qualified stock purchase for which a section 338(g) election is made. The tax rate in Country F is 25 percent. Assume further that the aggregate basis difference in connection with the qualified stock purchase is 200u, including: (1) 150u that is attributable to Asset A, with a 15-year recovery period for U.S. tax purposes (10u of annual amortization); and (2) 50u that is attributable to Asset B, with a 5-year recovery period (10u of annual depreciation). In each of years 1 and 2, FT’s taxable income is 100u for local tax purposes and FT pays foreign income tax of 25u (equal to \$25 when translated at the average exchange rate for the year). As a result, the disqualified portion of foreign income tax in each of years 1 and 2 is \$5  $((10u + 10u \text{ of allocable basis difference} / 100u \text{ of foreign taxable income}) \times \$25 \text{ foreign tax paid})$ .

In year 3, FT’s taxable income is 140u, 40u of which is attributable to gain on the sale of Asset B. FT’s Country F tax is 35u (equal to \$35 translated at the average exchange rate for the year). Accordingly, the disqualified portion of its foreign income taxes paid is \$10  $((40u \text{ (including 10u of annual amortization on Asset A and 30u attributable to disposition of Asset B) of allocable basis difference} / 140u \text{ of foreign taxable income}) \times \$35 \text{ foreign tax paid})$ .

An asset is a “relevant foreign asset” with respect to any covered asset acquisition, whether the entity acquired is domestic or foreign, only if any income, deduction, gain, or loss attributable to such asset (including goodwill, going concern value, and any other intangible asset) is taken into account in determining foreign income tax in the relevant jurisdiction. For this purpose, the term “foreign income tax” means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States, including any tax paid in lieu of such a tax within the meaning of section 903. In cases in which there has been a covered asset acquisition that involves either (1) both U.S. assets and relevant foreign assets, or (2) assets in multiple relevant jurisdictions, it is anticipated that the Secretary may issue regulations clarifying the manner in which any relevant foreign asset (such as intangible assets that may relate to more than one jurisdiction) will be allocated between those jurisdictions. It is also anticipated that the Secretary may issue regulations to clarify the extent to which income is considered attributable to a relevant foreign asset, as well as the treatment of an asset that ceases to be taken into account in determining the foreign income tax in the relevant jurisdiction by some mechanism other than a disposition.

To the extent that a foreign tax credit is disallowed, the disqualified portion is allowed as a deduction to the extent otherwise deductible.<sup>543</sup>

The Secretary may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of this provision, including to provide (1) an exemption for certain covered asset acquisitions, and (2) an exemption for relevant foreign assets with respect to which the basis difference is de minimis. For example, it is anticipated that the Secretary will exclude covered asset acquisitions that are not taxable for U.S. purposes, or in which the basis of the relevant foreign assets is also increased for purposes of the tax laws of the relevant jurisdiction.

### **Effective Date**

In general, the provision is effective for covered asset acquisitions after May 20, 2010, in cases in which the transferee and transferor are related, and the date of enactment in all other cases. However, the provision does not apply to any covered asset acquisition with respect to which the transferor and transferee are not related if such acquisition is (1) made pursuant to a written agreement that was binding on May 20, 2010, and at all times thereafter, (2) described in a ruling request<sup>544</sup> submitted to the IRS on or before such date, or (3) described in a public announcement or filing with the SEC on or before such date.

For this purpose, a person shall be treated as related to another person if the relationship between such persons is described in sections 267 or 707(b).

### **3. Separate application of foreign tax credit limitation, etc., to items resourced under treaties (sec. 403 of the bill and sec. 904(d) of the Code)**

### **Present Law**

The United States taxes its citizens and residents (including domestic corporations) on 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. Subject to limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for foreign income taxes paid or accrued.<sup>545</sup> 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 by the foreign corporation that the domestic corporation is deemed to have paid when the foreign

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<sup>543</sup> Sec. 164(a)(3).

<sup>544</sup> A private letter ruling may be relied upon only by the taxpayer requesting the ruling. Transition relief is available only with respect to the transaction for which the ruling is requested.

<sup>545</sup> Sec. 901.

corporation's earnings are distributed or included in the domestic corporation's income under the provisions of subpart F.<sup>546</sup>

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.<sup>547</sup> Other foreign levies generally are treated as deductible expenses. The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>548</sup>

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).<sup>549</sup> 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.<sup>550</sup>

The foreign tax credit limitation is generally applied separately for income in two different categories (referred to as "baskets"), passive category income and general category income.<sup>551</sup> Passive category income generally includes investment income such as dividends, interest, rents, and royalties.<sup>552</sup> 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.

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<sup>546</sup> Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

<sup>547</sup> Secs. 901(b), 903.

<sup>548</sup> Sec. 164(a)(3).

<sup>549</sup> Secs. 901, 904.

<sup>550</sup> Sec. 904(c).

<sup>551</sup> 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(h)(10), 865(h).

<sup>552</sup> 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.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).<sup>553</sup> Passive income is also treated as general basket 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).<sup>554</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a 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 basket of income out of which the dividend or other payment is made.<sup>555</sup> Dividends received by a 10-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>556</sup>

In general, amounts derived from a foreign corporation (such as interest and dividends) are treated as foreign-source income for U.S. foreign tax credit limitation purposes. A special sourcing rule applies to amounts (such as interest and dividends) derived from a U.S.-owned foreign corporation that are attributable to U.S.-source income of the foreign corporation. This special sourcing rule treats such amounts, which would otherwise be treated as foreign source, as U.S. source.<sup>557</sup> For these purposes, a U.S.-owned foreign corporation is a foreign corporation that is at least 50-percent owned (directly or in certain cases indirectly) by vote or value by U.S. persons. The effect of sourcing what under the general rules would be foreign-source income as U.S.-source income under these special rules is to prevent taxpayers from routing U.S.-source income through a foreign affiliate to increase the taxpayer's foreign-source income and, therefore, the taxpayer's foreign tax credit limitation.

A coordination rule applies in the case of an amount that would be treated as U.S.-source income under the special sourcing rule but which is treated as foreign source under a treaty. If (1) any amount derived from a U.S.-owned foreign corporation would be treated as U.S.-source income under the special sourcing rule described above, (2) a U.S. treaty obligation would treat such income as arising from sources outside the United States, and (3) the taxpayer chooses the benefits of this coordination rule, then the amount will be treated as foreign source. However, for foreign tax credit limitation purposes, a separate limitation applies to such amount and the associated foreign taxes. This coordination rule applies only to amounts derived from a U.S.-owned foreign corporation, and not to amounts derived from a foreign branch or disregarded entity.

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<sup>553</sup> Sec. 904(d)(2)(C), (D).

<sup>554</sup> Sec. 904(d)(2)(F).

<sup>555</sup> Sec. 904(d)(3).

<sup>556</sup> Sec. 904(d)(4).

<sup>557</sup> Sec. 904(h). The special sourcing rule applies in the case of subpart F and passive foreign investment company inclusions to the extent that such amount is attributable to income of the U.S.-owned foreign corporation from U.S. sources; in the case of dividends, to the portion of the U.S.-owned foreign corporation's earnings and profits for the taxable year that are from U.S. sources; and in the case of interest paid to a U.S. shareholder or related person, to amounts properly allocable to the U.S.-owned foreign corporation's U.S.-source income. De minimis exceptions apply if the U.S.-owned foreign corporation has a small amount of U.S.-source income.

For gains from the sale of certain stock or intangibles, a similar special sourcing rule applies to treat any such gain as foreign source, while requiring the taxpayer to assign any such gain and associated taxes to a separate limitation category for purposes of computing the foreign tax credit.<sup>558</sup> This rule applies to the gain from sale of stock in a foreign corporation or an intangible that would be U.S. source but which under a U.S.-treaty obligation is treated as foreign source with respect to which the taxpayer chooses the benefits of this rule. This rule also applies to certain gains derived from a liquidating distribution from certain U.S.-possession corporations.

### **Explanation of Provision**

The provision applies a separate foreign tax credit limitation for each item that (1) would be treated as derived from sources within the United States, (2) would be treated as arising from sources outside the United States under a treaty obligation of the United States, and (3) the taxpayer chooses the benefits of such treaty.

The provision does not apply to items of income to which the coordination rule applicable to U.S.-owned foreign corporations or the rule for gains from the sale of certain stock or intangibles (discussed above) apply. The provision gives the Secretary authority to issue guidance as necessary or appropriate to carry out the purposes of the provision, including guidance providing that related items of income may be aggregated for purposes of the provision or grouping together items of income from the same trade or business.

### **Effective Date**

The provision is effective for taxable years beginning after the date of enactment.

## **4. Limitation on the amount of foreign taxes deemed paid with respect to section 956 inclusions (sec. 404 of the bill and sec. 960 of the Code)**

### **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; 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 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 main anti-deferral

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<sup>558</sup> Sec. 865(h).

regimes are the controlled foreign corporation (“CFC”) rules of subpart F<sup>559</sup> and the passive foreign investment company rules.<sup>560</sup>

### **The subpart F CFC rules**

Under the subpart F CFC rules, a 10 percent-or-greater U.S. shareholder (a “U.S. Shareholder”) of a CFC is subject to U.S. tax currently on (1) its pro rata share of certain income earned by the CFC<sup>561</sup> and (2) certain untaxed earnings invested in U.S. property with respect to such shareholder.<sup>562</sup> In each case, the U.S. Shareholder is subject to tax currently, whether or not such income is distributed. A CFC is defined generally as a foreign corporation with respect to which U.S. Shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.<sup>563</sup>

#### **U.S. property held by CFCs**

A U.S. Shareholder that owns stock in a CFC on the last day of the taxable year must include in its gross income the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not previously taxed<sup>564</sup>) (a “section 956 inclusion”).<sup>565</sup> The section 956 inclusion for any taxable year is generally the lesser of (1) the excess of such shareholder’s pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year over the amount of previously taxed income from prior section 956 inclusions<sup>566</sup> with respect to such shareholder, or (2) such shareholder’s pro rata share of the applicable earnings of such CFC.<sup>567</sup>

### **Foreign tax credits**

Subject to the limitations discussed below, a U.S. person is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. As discussed below, a domestic corporation may<sup>568</sup> also be allowed a “deemed-paid” credit for foreign income

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<sup>559</sup> See secs. 951-964.

<sup>560</sup> See secs. 1291-1298.

<sup>561</sup> Sec. 951(a)(1)(A).

<sup>562</sup> Sec. 951(a)(1)(B).

<sup>563</sup> Sec. 957(a).

<sup>564</sup> Sec. 959(a)(2).

<sup>565</sup> Sec. 951(a)(1)(B).

<sup>566</sup> See sec. 959(c)(1)(A).

<sup>567</sup> Sec. 956(a).

<sup>568</sup> A U.S. Shareholder includes individuals and entities. Sec. 951(b). In contrast, only those U.S. Shareholders that are corporations are entitled to the deemed-paid credit.



taxes paid by a 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, including section 956 inclusions.<sup>569</sup>

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. The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.<sup>570</sup>

#### Deemed-paid foreign tax credit

Domestic corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits ("E&P") become subject to U.S. tax as dividend income of the domestic corporation.<sup>571</sup> This credit is the deemed-paid, or indirect, foreign tax credit. A domestic corporation may also be deemed to have paid taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.<sup>572</sup> Foreign taxes paid below the third tier are eligible for the deemed-paid credit only with respect to taxes paid in taxable years during which the payor is a CFC and the corporation claiming the credit is a U.S. Shareholder of the CFC.<sup>573</sup> Foreign taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to any inclusion of subpart F income or investments of earnings in U.S. property for the taxable year.<sup>574</sup> The amount of the credit is determined by the same formula as under section 902, except that the numerator of the ratio is the amount of the inclusion, rather than the amount of dividends received during the taxable year.<sup>575</sup>

E&P is determined under the same rules for purposes of the deemed-paid credit fraction with respect to subpart F and section 956 inclusions as for dividends.<sup>576</sup> These rules generally<sup>577</sup> provide that the E&P of any foreign corporation is determined according to rules substantially

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<sup>569</sup> Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

<sup>570</sup> Sec. 164(a)(3).

<sup>571</sup> Sec. 902(a).

<sup>572</sup> Sec. 902(b).

<sup>573</sup> Sec. 902(b)(2).

<sup>574</sup> Sec. 960(a).

<sup>575</sup> Sec. 960(a)(1); Treas. Reg. sec. 1.960-1(i)(1).

<sup>576</sup> See secs. 902(c)(1), 964; Treas. Reg. sec. 1.964-1(a)(1).

<sup>577</sup> For an exception, see sec. 312(k)(4).

similar to those applicable to domestic corporations, under regulations prescribed by the Secretary. The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be “grossed-up”) and is included in the domestic corporation’s income; accordingly, the domestic corporation is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation.<sup>578</sup>

For purposes of computing the deemed-paid foreign tax credit, distributions (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation’s accumulated E&P.<sup>579</sup> Accumulated E&P for this purpose includes the E&P of the current year undiminished by the current distribution (or other inclusion).<sup>580</sup> Distributions in excess of the accumulated pool of post-1986 undistributed E&P are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.<sup>581</sup>

#### Foreign tax credit limitation

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).<sup>582</sup> 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.<sup>583</sup>

The foreign tax credit limitation is generally applied separately to two different categories of income, passive category income and general category income.<sup>584</sup> Passive category income generally includes investment income such as dividends, interest, rents, and royalties.<sup>585</sup> General

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<sup>578</sup> Sec. 78.

<sup>579</sup> Sec. 902(c)(6)(B). E&P computations for these purposes are to be made under U.S. tax principles. Secs. 902(c)(1), 964(a).

<sup>580</sup> Sec. 902(c)(1).

<sup>581</sup> Sec. 902(c)(6).

<sup>582</sup> Secs. 901, 904.

<sup>583</sup> Sec. 904(c).

<sup>584</sup> 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(h)(10), 865(h).

<sup>585</sup> 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

category income is generally all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two categories, credits for foreign tax imposed on income in one category cannot be used to offset U.S. tax on income in the other category.

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).<sup>586</sup> 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).<sup>587</sup> Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person are assigned to a separate limitation category by reference to the category of income out of which the dividend or other payment is made.<sup>588</sup> Dividends received by a U.S. person from a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>589</sup> For purposes of determining the foreign tax credit limitation, section 956 inclusions are treated as dividends.<sup>590</sup>

Under the foreign tax credit limitation rules, the total amount of the credit taken into account cannot exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's taxable income) bears to his entire taxable income for the same taxable year.

### **Explanation of Provision**

The provision imposes a limit on the amount of foreign taxes that a U.S. Shareholder is deemed to pay under the foreign tax credit rules with respect to any section 956 inclusion.

For section 956 inclusions attributable to U.S. property acquired by a CFC after the effective date, the amount of foreign taxes deemed paid in each separate category is determined by comparing the foreign taxes deemed paid with respect to the U.S. Shareholder's section 956 inclusion (determined without regard to the provision) (the "tentative credit") to its hypothetical amount of foreign taxes deemed paid as computed under the provision (the "hypothetical credit"). The U.S. Shareholder's hypothetical credit is the amount of foreign taxes it would have

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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.

<sup>586</sup> Sec. 904(d)(2)(C), (D).

<sup>587</sup> Sec. 904(d)(2)(F).

<sup>588</sup> Sec. 904(d)(3).

<sup>589</sup> Sec. 904(d)(4).

<sup>590</sup> Sec. 904(d)(3)(G).

been deemed to have paid if cash in an amount equal to the section 956 inclusion had been distributed through the chain of ownership that begins with the foreign corporation that holds the investment in U.S. property and ends with the U.S. Shareholder. If the hypothetical credit is less than the tentative credit, then the amount of foreign taxes deemed paid with respect to the section 956 inclusion is limited to the hypothetical credit. However, the amount of the tentative credit is not increased if the hypothetical credit would have been greater than the tentative credit. This limitation applies whether the U.S. Shareholder chooses to claim a credit<sup>591</sup> for foreign taxes paid or accrued, or to deduct such taxes.<sup>592</sup>

In general, no special rules apply in determining the hypothetical credit. The only exception is that, to the extent an actual distribution would be subject to any income or withholding tax, such taxes are not taken into account in determining the hypothetical credit.<sup>593</sup> Thus, the generally applicable rules and definitions<sup>594</sup> apply to each hypothetical distribution. For example, assume that, for the relevant tax year, and before taking into account the hypothetical distribution under the provision, a U.S. parent (“USP”) owns all of the vote and value of CFC1, a CFC organized in Country A with post-1986 undistributed earnings of 200u, and post-1986 foreign income taxes in the amount of \$10.<sup>595</sup> CFC1 owns all of the vote and value of CFC2, a CFC organized in Country B with post-1986 undistributed earnings of 100u, and post-1986 foreign income taxes in the amount of \$50. If CFC2 makes a loan to USP that results in a section 956 inclusion in the amount of 100u, the tentative credit is \$50 (equal to 100u/100u x \$50).

The hypothetical distribution of 100u from CFC2 to CFC1 would increase CFC1’s current E&P by 100u, from 200u to 300u, and increase CFC1’s foreign income taxes from \$10 to \$60. The 100u hypothetical distribution results in a dividend of 100u that is non-subpart F income of CFC1 under the subpart F look-through rules.<sup>596</sup> Although Country B would impose a

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<sup>591</sup> Sec. 901.

<sup>592</sup> Sec. 164(a)(3).

<sup>593</sup> Similarly, if this hypothetical distribution would be subject to a withholding tax upon distribution to USP, if it had been actually made, any such tax would not be taken into account in determining the hypothetical credit. However, this conclusion results because such taxes are described in section 901(b), thus they are outside the scope of the provision.

<sup>594</sup> See, e.g., secs. 902(b), (c), and 904(d)(3)(B), (D).

<sup>595</sup> For purposes of this example, assume that each CFC has: (1) a “u” functional currency; (2) E&P comprising solely post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, such that there are no pre-1987 accumulated profits; (3) only post-1986 foreign income taxes; (4) no previously-taxed income; (5) only E&P and foreign income taxes in the section 904(d) general category; and (6) no other attributes than those listed. Except as provided in the example, there are no other distributions or inclusions during the taxable year. In addition, Country B imposes a 10-percent withholding tax on dividend payments to foreign shareholders.

<sup>596</sup> Sec. 954(c)(6). This assumes that the subpart F look-through rules of section 954(c)(6) are extended, and are therefore applicable to the hypothetical distribution. In the event the look-through rule of section 954(c)(6) expires, the 100u hypothetical distribution would result in a dividend of 100u that would be currently included in USP's income as a subpart F item at the level of CFC1.

10 percent withholding tax on an actual distribution of 100u to CFC1, for a total withholding tax of 10u, this amount is not taken into account in determining the hypothetical credit. Next, the 100u hypothetical distribution from CFC1 to USP would result in a dividend of 100u, on which USP would be deemed to have paid \$20 in taxes.<sup>597</sup> Because the hypothetical credit of \$20 is less than the tentative credit of \$50, USP's foreign taxes deemed paid with respect to its section 956 inclusion are limited to \$20. USP's section 78 gross-up with respect to the section 956 inclusion is also \$20.<sup>598</sup>

The provision is applied with regard to earnings and taxes in each separate category. In addition, treatment of any foreign taxes over the limit imposed under the provision (the "excess taxes") is the same as the treatment of any other foreign taxes paid or accrued, but not yet deemed paid for purposes of the foreign tax credit rules. Thus, if a foreign corporation's excess taxes are in its general category post-1986 foreign income taxes pool, the foreign corporation's excess taxes are still considered general category post-1986 foreign income taxes.<sup>599</sup> Accordingly, such taxes are included in the computation of foreign taxes deemed paid with respect to a subsequent distribution from, or income inclusion with respect to, that foreign corporation, subject to applicable limitations including the limitation of the provision. In the example above, excess taxes that remain at CFC2 equal \$30.<sup>600</sup>

The provision applies to U.S. property acquired by a CFC after May 20, 2010. Thus, for example, any section 956 inclusions from a CFC loan that was made to its U.S. parent on or before May 20, 2010 would not be subject to the limitation imposed by the provision. However, the limitation imposed by the provision would apply if, after May 20, 2010, there is a significant modification of the debt instrument such that the original debt instrument is considered as exchanged for a modified instrument that differs materially from the original.<sup>601</sup>

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<sup>597</sup> The hypothetical amount of foreign taxes deemed paid equals  $(100u/300u) \times \$60$ . The post-1986 undistributed earnings that is the denominator of the section 902(a) fraction for purposes of the provision equals CFC1's post-1986 undistributed earnings of 200u (determined without regard to the provision) plus the amount of the hypothetical dividend from CFC2, 100u.

<sup>598</sup> If, in the same taxable year, CFC1 were also to make an actual distribution of all its accumulated E&P of 200u, the 100u hypothetical distribution from CFC1 to USP would have no impact on the calculation of USP's actual deemed paid credit from CFC1's actual dividend. The deemed-paid credit on the 200u dividend would be \$10, which equals  $(200u/200u) \times \$10$ . In addition, the calculation of the hypothetical credit with respect to the hypothetical distribution of 100u from CF2 would be the same  $(100u/300u \times \$60 = \$20)$  whether or not CFC1 paid an actual dividend.

<sup>599</sup> Sec. 902(c)(2).

<sup>600</sup> The excess taxes equal the deemed paid foreign tax credit (determined without regard to the provision) of \$50 minus the hypothetical credit of \$20. Alternatively, if CFC2's E&P also included 125u in previously taxed income, then the excess taxes remaining at CFC2 would be \$50, because the applicable ordering rules would prioritize the hypothetical distribution as coming first from the 125u in previously taxed income over the 100u in untaxed earnings. See sec. 959(c).

<sup>601</sup> See Treas. Reg. sec. 1.1001-3.

The provision requires the Secretary to issue regulations to carry out its purposes, including regulations that prohibit inappropriate use of excess taxes. It is anticipated that such regulations would address transactions engaged in with a principal purpose to avoid the application of this provision, including through a series of transactions engaged in pursuant to a plan with such a principal purpose.

### **Effective Date**

The provision is effective for acquisitions of United States property made by CFC's after May 20, 2010.

## **5. Special rule with respect to certain redemptions by foreign subsidiaries (sec. 405 of the bill and sec. 304(b) of the Code)**

### **Present Law**

Under section 304, if one corporation (the “acquiring corporation”) purchases stock of a related corporation (the “target corporation”) in exchange for property, the transaction generally is recharacterized as a redemption. To the extent a section 304(a)(1) transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the 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.<sup>602</sup> In the case of a section 304 transaction, the amount and the source of a dividend are determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits (“E&P”), and then by the target corporation to the extent of its E&P.<sup>603</sup> To the extent the dividend is sourced from the E&P of the acquiring corporation, the transferor is considered to receive the dividend directly from the acquiring corporation;<sup>604</sup> this is commonly referred to as “hopscotching” because the dividend bypasses any intermediary shareholders.

Special rules apply if the acquiring corporation is foreign.<sup>605</sup> For purposes of determining the amount of the dividend to the transferor, the foreign acquiring corporation's E&P that is taken into account is limited to the portion of such E&P that (1) is 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<sup>606</sup> of the foreign acquiring corporation and (2) was accumulated while such stock was owned by the

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<sup>602</sup> Sec. 304(a)(1).

<sup>603</sup> Sec. 304(b)(2).

<sup>604</sup> See H.R. Rep. No. 98-861 (1984) (Conf. Rep.), 1222-1224; Rev. Rul. 80-189, 1980-2 C.B. 106.

<sup>605</sup> Sec. 304(b)(5).

<sup>606</sup> As that term is defined by section 951(b).

transferor (or a person related thereto) and while the foreign acquiring corporation was a controlled foreign corporation (“CFC”).<sup>607</sup>

Section 1442 generally requires a 30-percent gross basis tax to be withheld on dividend payments to foreign persons unless reduced or eliminated pursuant to an applicable income tax treaty.

### **Explanation of Provision**

The provision generally imposes an additional limitation on the E&P of a foreign acquiring corporation that is taken into account in determining the amount (and source) of the distribution that is treated as a dividend.

Under the provision, if more than 50 percent of the dividends arising from acquisition (before taking into account the provision) would not be (1) subject to U.S. tax in the year in which the dividend arises or (2) includible in the E&P of a CFC,<sup>608</sup> then the E&P of the foreign acquiring corporation is not taken into account. Thus, the special rule generally applies if more than 50 percent of the target corporation is acquired from a foreign person that is not a CFC.

If it is determined that the special rule applies, none of the foreign acquiring corporation’s E&P is taken into account. In such case, the only E&P that is taken into account to determine the amount constituting a dividend is the target corporation’s E&P. Where applicable, the special rule effectively prevents the foreign acquiring corporation’s E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation. Generally, if the transferor is a foreign corporation (and not a CFC) and the acquiring corporation is a CFC, it is not relevant whether the target corporation is a domestic or a foreign corporation. However, if the target is a U.S. corporation, the 30-percent gross basis withholding tax applies to the amount constituting a dividend from the target, unless reduced or eliminated by treaty.<sup>609</sup>

It is anticipated that regulations will provide a rule to prevent the avoidance of the provision, including through the use of partnerships, options, or other arrangements to cause a foreign corporation to be treated as a CFC.

### **Effective Date**

The provision is effective for acquisitions after May, 20, 2010.

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<sup>607</sup> See sec. 304(b)(5).

<sup>608</sup> For purposes of this rule, “CFC” is defined by reference to section 957, but without regard to section 953(c).

<sup>609</sup> Sec. 1442; Rev. Rul. 92-85; 1992-2 C.B. 69.

## **6. Modification of affiliation rules for purposes of rules allocating interest expense (sec. 406 of the bill and sec. 864 of the Code)**

### **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; the foreign tax credit provides relief from double taxation. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.<sup>610</sup>

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources by allocating and apportioning deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other. There are no specific rules for most types of deductions.<sup>611</sup> Specific provisions govern the allocation and apportionment of interest.<sup>612</sup>

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.<sup>613</sup>

#### **Foreign corporations owned by an affiliated group of corporations**

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.<sup>614</sup> These rules exclude all foreign corporations from an affiliated group.<sup>615</sup> Thus, while debt generally is

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<sup>610</sup> Secs. 901, 904.

<sup>611</sup> See, e.g., secs. 861(b), 862(b), and 863(a), which require that a taxpayer properly allocate and apportion expenses, losses, or other deductions, without containing any specific rules for allocating and apportioning particular types of deductions.

<sup>612</sup> Sec. 864(e). In the case of interest expense, the rules generally are based on the premise that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. Temp. Reg. sec. 1.861-9T(a).

<sup>613</sup> Secs. 864(e)(1), 864(e)(2).

<sup>614</sup> Secs. 864(e)(5)(A), sec. 1504. The affiliated group for interest allocation purposes generally excludes certain corporations that are financial institutions. These corporate financial institutions are not treated as members of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such corporate financial institutions that would be so affiliated are treated as a separate single corporation for interest allocation purposes. Sec. 864(e)(5)(B).

<sup>615</sup> Sec. 1504(b)(3).



considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Under Treasury regulations, however, certain foreign corporations are treated as affiliated corporations, in certain respects, if (1) at least 80 percent of either the vote or value of the corporation's outstanding stock is owned directly or indirectly by members of an affiliated group, and (2) more than 50 percent of the corporation's gross income for the taxable year is effectively connected with the conduct of a U.S. trade or business (also known as effectively connected income).<sup>616</sup>

In the case of a foreign corporation that is treated as an affiliated corporation for interest allocation and apportionment purposes, the percentage of its assets and income that is taken into account varies depending on the percentage of the corporation's gross income that is effectively connected income. If 80 percent or more of the foreign corporation's gross income is effectively connected income, then all the corporation's assets and interest expense are taken into account. If, instead, between 50 percent and 80 percent of the foreign corporation's gross income is effectively connected income, then only the corporation's assets that generate effectively connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively connected income are taken into account.<sup>617</sup>

### **Explanation of Provision**

The provision treats a foreign corporation as a member of an affiliated group, for interest allocation and apportionment purposes, if (1) more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected income, and (2) at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). Thus, under the provision, if more than 50 percent of a foreign corporation's gross income is effectively connected income and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group, then all of the foreign corporation's assets and interest expense are taken into account for the purposes of allocating and apportioning the interest expense of the affiliated group.

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<sup>616</sup> Temp. Reg. sec. 1.861-11T(d)(6)(ii). The question as to whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person. Generally, only U.S.-source income is treated as effectively connected with the conduct of a U.S. trade or business. However, certain limited categories of foreign-source income are treated as effectively connected if the income is attributable to an office or other fixed place of business maintained by the foreign person in the United States. Sec. 864(c).

<sup>617</sup> Temp. Reg. sec. 1.861-11T(d)(6)(ii).

### **Effective Date**

The provision applies to taxable years beginning after the date of enactment.

## **7. Termination of special rules for interest and dividends received from persons meeting the 80-percent foreign business requirements (sec. 407 of the bill and secs. 861(a)(1)(A) and 871(i) of the Code)**

### **Present Law**

The source of interest and dividend income generally is determined by reference to the country of residence of the payor.<sup>618</sup> Thus, an interest or dividend payment from a U.S. payor to a foreign person generally is treated as U.S.-source income and is subject to the 30-percent gross-basis U.S. withholding tax.<sup>619</sup> However, if a resident alien individual or domestic corporation satisfies an 80-percent active foreign business income requirement (the “80/20 test”), all or a portion of any interest paid by the resident alien individual or the domestic corporation (a so-called “80/20 company”) is exempt from U.S. withholding tax. Interest paid by a resident alien individual that satisfies the 80/20 test or by an 80/20 company is treated as foreign-source income and is therefore exempt from the 30-percent withholding tax if it is paid to unrelated parties.<sup>620</sup> When a resident alien individual or 80/20 company pays interest to a related party, the resourcing rule applies only to the percentage of the interest that is equal to the percentage of the resident alien individual’s or 80/20 company’s foreign-source income (described below) as a portion of the resident alien individual’s or 80/20 company’s total gross income during the three-year testing period (a so-called “look-through” approach).<sup>621</sup>

In addition to interest, all or part of a dividend paid by an 80/20 company may also be exempt from U.S. withholding tax. The percentage of the dividend paid by an 80/20 company that equals the percentage of the 80/20 company’s total gross income during the testing period that is foreign source is exempt from U.S. withholding tax.<sup>622</sup> Unlike interest, a dividend paid by an 80/20 company remains U.S. source (for example, for foreign tax credit limitation purposes).

In general, a resident alien individual or domestic corporation meets the 80/20 test if at least 80 percent of the gross income of the resident alien individual or corporation during the testing period is derived from foreign sources and is attributable to the active conduct of a trade or business in a foreign country (or a U.S. possession) by the resident alien individual or corporation or, in the case of a corporation, a 50-percent owned subsidiary of that corporation.

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<sup>618</sup> Secs. 861(a)(1), (2), 862(a)(1), (2).

<sup>619</sup> Secs. 871(a)(1)(A), 881(a)(1), 1441(b), 1442(a).

<sup>620</sup> Sec. 861(a)(1)(A).

<sup>621</sup> Sec. 861(c)(2).

<sup>622</sup> Sec. 871(i).

The testing period generally is the three-year period preceding the year in which the interest or dividend is paid.<sup>623</sup>

### **Explanation of Provision**

The provision repeals the present law rule that treats as foreign source all or a portion of any interest paid by a resident alien individual or domestic corporation that meets the 80/20 test. The provision also repeals the present law rule that exempts from U.S. withholding tax all or a portion of any dividends paid by a domestic corporation that meets the 80/20 test.

The provision provides a grandfather rule for any domestic corporation that (1) meets the 80/20 test (as in effect before the enactment of this subsection) (hereinafter “the present law 80/20 test”) for its last taxable year beginning before January 1, 2011 (“an existing 80/20 company”), (2) meets a “new 80/20 test” with respect to each taxable year beginning after December 31, 2010, and (3) has not added a substantial line of business with respect to such corporation after the date of enactment of this provision. Any payment of dividend or interest after December 31, 2010 by an existing 80/20 company that meets the grandfather rule will be exempt from withholding tax to the extent of the existing 80/20 company’s active foreign business percentage. Nonetheless, any payment of interest will be treated as U.S.-source income.

As with the present law 80/20 test, a corporation meets the new 80/20 test if its active foreign business percentage - the percentage that the active foreign income of such company is of the total gross income of the company - is at least 80-percent during the testing period. However, for this purpose, the existing 80/20 company and all of its subsidiaries shall be treated as one corporation. For this purpose, a subsidiary includes any corporation in which the existing 80/20 company owns (directly or indirectly) stock meeting the requirements of section 1504(a)(2) (determined by substituting 50-percent for 80-percent) without regard to section 1504(b)(3). As a result, an existing 80/20 company must take into account the gross income of any domestic or foreign subsidiary for purposes of determining its active foreign business percentage. The Secretary may issue guidance as is necessary or appropriate to carry out the purpose of this provision including the proper application of these aggregation rules.

Under the new 80/20 test, the term testing period means the three-year period ending with the close of the taxable year of the corporation preceding the payment (or such part of such period as may be applicable). If the corporation has no gross income for such three-year period (or part thereof), the testing period is the taxable year in which the payment is made.

An existing 80/20 company does not meet the grandfather rule if there has been an addition of a substantial line of business with respect to such corporation after the date of enactment of this provision. For purposes of determining whether a substantial line of business has been added, rules similar to those of section 7704(g) and the Treasury regulations thereunder

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<sup>623</sup> Sec. 861(c)(1). The income of a subsidiary is attributed to the tested company only to the extent that the tested company actually receives income from the subsidiary in the form of dividends. *Conference Report to the 1986 Tax Reform Act*, Pub. L. No. 99-514, Vol II, 602. See also Rev. Rul. 73-63, 1973-1 C.B. 336 and P.L.R. 6905161160A (May 16, 1969).

(relating to certain publicly-traded partnerships treated as corporations) apply. It is anticipated that the Secretary will issue guidance providing that the acquisition of foreign operating assets or stock of a foreign corporation by the existing 80/20 company for the purpose of increasing its active foreign business percentage will be treated as the addition of a substantial line of business.

The repeal of the 80/20 company provisions relating to the payment of interest does not apply to payments of interest to persons not related to the 80/20 company (applying rules similar to those of section 954(d)(3)) on obligations issued before the date of enactment.<sup>624</sup> For this purpose, a significant modification of the terms of any obligation (including any extension of the term of such obligation) is treated as the issuance of a new obligation.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2010.

## **8. Source rules for income on guarantees (sec. 408 of the bill and secs. 861, 862 & 864 of the Code)**

### **Present Law**

The United States taxes U.S. citizens and residents (including domestic corporations) on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations engaged in a trade or business in the United States on income that is effectively connected with the conduct of such trade or business (sometimes referred to as “effectively connected income”). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with the conduct of a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are connected with effectively connected income.<sup>625</sup> A foreign corporation also is subject to a flat 30-percent branch profits tax on its “dividend equivalent amount,” which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business.<sup>626</sup> In addition, a

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<sup>624</sup> A person will be treated as a related person with respect to a controlled foreign corporation if (A) such person is an individual, corporation, partnership, trust or estate which controls, or is controlled by, the controlled foreign corporation, or (B) such person is a corporation, partnership, trust or estate which is controlled by the same person or persons which control the resident controlled foreign corporation. For purposes of the preceding sentence, control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of stock of such corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests in such partnership, trust, or estate. For purposes of this paragraph, rules similar to the rules of section 958 shall apply. Sec. 954(d)(3).

<sup>625</sup> Secs. 864(c), 871(b), 873, 882(a) and 882(c).

<sup>626</sup> Sec. 884.

foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.<sup>627</sup>

Subject to a number of exceptions, U.S.-source fixed or determinable, annual or periodical income (“FDAP”) of a nonresident alien individual or foreign corporation that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid.<sup>628</sup> Items of income within the scope of FDAP include, for example, interest, dividends, rents, royalties, salaries, and annuities. The tax generally is collected by means of withholding.<sup>629</sup>

Present law provides detailed rules for the determination of whether income is from U.S. sources or foreign sources. For example, the source of compensation for services is generally determined by the location in which the services were performed, regardless of the country of residence of the payor.<sup>630</sup> In contrast, the source of interest income is generally determined by reference to the country of residence of the obligor.<sup>631</sup> As a result, interest paid by a U.S. obligor typically is considered U.S.-source income, while interest paid by a foreign obligor is treated as foreign-source income. Rents and royalties paid for the use of property located in the United States are considered to be U.S.-source income.<sup>632</sup>

Many items of income are not explicitly addressed by either the statute or the regulations thereunder. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.<sup>633</sup> As a result, items as dissimilar as alimony and letters of credit commissions were sourced by analogy to interest,<sup>634</sup> while more recently, the fees paid by a U.S. corporation to its foreign parent with respect to guarantees issued by the parent for the

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<sup>627</sup> Sec. 884(f).

<sup>628</sup> Secs. 871(a), 881(a).

<sup>629</sup> Sec. 1441 and 1442 provide for collection from nonresident aliens and foreign corporations, respectively.

<sup>630</sup> Under section 861(a)(3), compensation for personal services performed in the United States is U.S. source, unless the individual performing the services is a nonresident alien who is temporarily present in the United States, receives no more than \$3,000 of compensation and is performing the services for a foreign person not engaged in a U.S. trade or business. Conversely, section 862(a)(3) provides that compensation for labor or services performed outside the United States is foreign source.

<sup>631</sup> Secs. 861(a)(1), 862(a)(1).

<sup>632</sup> Sec. 861(a)(4).

<sup>633</sup> *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

<sup>634</sup> *Manning v. Commissioner*, 614 F.2d 815 (1st Cir. 1980); *Bank of America v. United States*, 230 Ct. Cl. 679, 680 F.2d 142 (1982), *aff’d in part, rev’d in part*, 47 AFTR 2d 81-652 (Ct. Cl. 1981).

creditworthiness of the subsidiary were sourced by analogy to services and thus sourced by reference to the residence of the foreign parent-guarantor.<sup>635</sup>

### **Explanation of Provision**

Under the provision, amounts received from noncorporate residents or domestic corporations with respect to guarantees are treated as income from sources within the United States. In addition, payments by foreign persons with respect to guarantees are treated as income from U.S. sources if the payments are connected with income effectively connected with the conduct by the payor of a U.S. trade or business. All other payments with respect to guarantees are treated as foreign source income. A transaction need not satisfy the definition of guarantee under section 163(j) in order to generate income with respect to a guarantee that is to be sourced according to this provision.

For purposes of this provision, the phrase “noncorporate residents” is to be construed to be consistent with section 861(a)(1), except that foreign partnerships are not included. Payments by foreign partnerships with respect to guarantees are U.S. source if such payments are connected with income which is effectively connected with the conduct of a U.S. trade or business. A conforming amendment to section 864 provides that amounts received with respect to guarantees are deemed to be effectively connected with the conduct of a U.S. trade or business if derived in the active conduct of banking, financing or a similar business. At a minimum, such transactions include guarantees with respect to indebtedness or creditworthiness, as well as agreements to warrant or indemnify certain securities transactions.

### **Effective Date**

The provision applies with respect to guarantees issued after the date of enactment. No inference is intended with respect to the source of income received with respect to guarantees issued before the date of enactment.

## **9. Modification of statute of limitations for failure to disclose certain foreign transactions (sec. 409 of the bill and sec. 6501(c) of the Code)**

### **Present Law**

Taxes are generally required to be assessed within three years after a taxpayer’s return was filed, whether or not it was timely filed.<sup>636</sup> In the case of a false or fraudulent return filed with the intent to evade tax, or if the taxpayer fails to file a required return, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.<sup>637</sup> The limitation period also may be extended by taxpayer consent.<sup>638</sup> If a taxpayer

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<sup>635</sup> *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010).

<sup>636</sup> Sec. 6501(a). Returns that are filed before the date they are due are deemed filed on the due date. See sec. 6501(b)(1) and (2).

<sup>637</sup> Sec. 6501(c).

engages in a listed transaction but fails to include any of the information required under section 6011 on any return or statement for a taxable year, the limitation period with respect to such transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is provided the information so required, or (2) the date that a “material advisor” (as defined in section 6111) makes its section 6112(a) list available for inspection pursuant to a request by the Secretary under section 6112(b)(1)(A).<sup>639</sup> In addition to the exceptions described above, there are also circumstances under which the three-year limitation period is suspended.<sup>640</sup>

Section 6501(c)(8) provides an exception to the three-year period of limitations due to failures to provide information about cross-border transactions or foreign assets. Under this exception, the limitation period for assessment of tax does not expire any earlier than three years after the required information about certain cross-border transactions or foreign assets is actually provided to the Secretary by the person required to file the return.<sup>641</sup> In general, such information reporting is due with the taxpayer’s return; thus, the three-year limitation period commences when a timely and complete return (including all information reporting) is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are subsequently provided to the Secretary, even though the return has been filed. The taxes that may be assessed during this suspended or extended period are not limited to those attributable to adjustments to items related to the information required to be reported by one of the enumerated sections.

### **Explanation of Provision**

The provision modifies the scope of the exception to the limitations period if a failure to provide information on cross-border transactions or foreign assets is shown to be due to reasonable cause and not willful neglect. In the absence of reasonable cause or the presence of willful neglect, the suspension of the limitations period and the subsequent three-year period that begins after information is ultimately supplied apply to all issues with respect to the income tax return. In cases in which a taxpayer establishes reasonable cause, the limitations period is suspended only for the item or items related to the failure to disclose. In order to prove reasonable cause, it is anticipated that a taxpayer must establish that the failure was objectively

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<sup>638</sup> Sec. 6501(c)(4).

<sup>639</sup> Sec. 6501(c)(10).

<sup>640</sup> For example, service of an administrative summons triggers the suspension either (1) beginning six months after service (in the case of John Doe summonses) or (2) when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record-keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

<sup>641</sup> Required information reporting subject to this three-year rule is reporting under sections 6038 (certain foreign corporations and partnerships), 6038A (certain foreign-owned corporations), 6038B (certain transfers to foreign persons), 6038D (individuals with foreign financial assets), 6046 (organizations, reorganizations, and acquisitions of stock of foreign corporations), 6046A (interests in foreign partnerships), and 6048 (certain foreign trusts), as well as information required with respect to elections under sections 1295(b) passive foreign investment corporations.

reasonable (i.e., the existence of adequate measures to ensure compliance with rules and regulations), and in good faith.

For example, the limitations period for assessing taxes with respect to a tax return filed on March 31, 2011 ordinarily expires on March 31, 2014. In order to assess tax with respect to any issue on the return after March 31, 2014, the IRS must be able to establish that one of the exceptions applies. If the taxpayer fails to attach to that return one of multiple information returns required, the limitations period does not begin to run unless and until that missing information return is supplied. Assuming that the missing report is supplied to the IRS on January 1, 2013, the limitations period for the entire return begins, and elapses no earlier than three years later, on January 1, 2016. All items are subject to adjustment during that time, unless the taxpayer can prove that reasonable cause for the failure to file existed. If the taxpayer establishes reasonable cause, the only adjustments to tax permitted after March 31, 2014 are those related to the failure to file the information return. For this purpose, related items include (1) adjustments made to the tax consequences claimed on the return with respect to the transaction that was the subject of the information return, (2) adjustments to any item to the extent the item is affected by the transaction even if it is otherwise unrelated to the transaction, and (3) interest and penalties that are related to the transaction or the adjustments made to the tax consequences.

#### **Effective Date**

The provision applies to returns filed after March 18, 2010, the date of enactment of “Hiring Incentives to Restore Employment Act,” Public Law 111-147, as well as for any other return for which the assessment period specified in section 6501 had not yet expired as of that date.



## **B. Personal Service Income Earned in Pass-thru Entities**

### **1. Income of partners for performing investment management services treated as ordinary income received for performance of services (secs. 411 and 412 of the bill and secs. 83, 710, 856, 1402, 6662, 6662A, 6664, and 7704 of the Code)**

#### **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 taxed upon the receipt of the partnership interest.<sup>642</sup>

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.<sup>643</sup> 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<sup>644</sup> clarifies that this treatment applies provided the service partner takes 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.<sup>645</sup>

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

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<sup>642</sup> 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 (7<sup>th</sup> 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 (8<sup>th</sup> Cir. 1991)).

<sup>643</sup> Rev. Proc. 93-27 (1993-2 C.B. 343) citing the *Diamond* and *Campbell* cases, *supra*.

<sup>644</sup> 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.

<sup>645</sup> 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).

performance of services.<sup>646</sup> 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.<sup>647</sup>

### **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.<sup>648</sup> 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.

#### **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.

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<sup>646</sup> 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).

<sup>647</sup> Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>648</sup> Sec. 83(h).

### 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.<sup>649</sup> 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 permit 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 in a partnership (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant), 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.<sup>650</sup> 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 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 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**

#### In general

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

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<sup>649</sup> 70 Fed. Reg. 29675 (May 24, 2005).

<sup>650</sup> Sec. 702.

Insurance Contributions Act (“FICA”).<sup>651</sup> A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act (“SECA”).<sup>652</sup>

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.<sup>653</sup> The amount of wages subject to this component is capped at \$106,800 for 2010. 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.<sup>654</sup>

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 2010. 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.<sup>655</sup> Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

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

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<sup>651</sup> See Chapter 21 of the Code.

<sup>652</sup> Sec. 1401.

<sup>653</sup> Secs. 3101 and 3111.

<sup>654</sup> 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.

<sup>655</sup> 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).

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.<sup>656</sup> 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.

#### Unearned income Medicare contribution

For taxable years beginning after 2012, in the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed. 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<sup>657</sup> 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.

The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

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

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation. Income, gain, or loss on working capital is not treated as derived from a trade or business.

In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately

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<sup>656</sup> Sec. 1402(a)(13).

<sup>657</sup> 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.

before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account.<sup>658</sup>

Net investment income does not include amounts subject to SECA tax. Thus, for example, in the case of a partner, the tax does not apply to any item taken into account in determining self-employment income for the taxable year on which tax is imposed under the self-employment tax rules.

### **Income tax treatment of publicly traded partnerships**

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.<sup>659</sup> For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). In the case of a partnership, a principal activity of which is the buying and selling of commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool), qualifying income also includes income and gains from such commodities, futures, options or forward contracts.

The rules generally treating publicly traded partnerships as corporations were enacted in 1987 to address concern about long-term erosion of the corporate tax base. At that time, Congress stated, “[t]o the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.”<sup>660</sup> Referring to recent tax law changes affecting corporations, the Congress stated, “[t]hese changes reflect an intent to preserve the corporate level tax. The committee is

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<sup>658</sup> For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.

<sup>659</sup> Sec. 7704(a).

<sup>660</sup> H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065.

concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax.”<sup>661</sup>

The 1987 legislation provided a transition rule grandfathering existing partnerships for 10 years. Under the transition rule, in the case of partnerships existing on December 31, 1987, the general rule treating publicly traded partnerships as corporations applies for taxable years beginning after December 31, 1997.<sup>662</sup> A partnership was not treated as an existing partnership for this purpose if a substantial new line of business was added.

### **Real estate investment trusts (REITs)**

A real estate investment trust (“REIT”) is an entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity’s organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income (other than net capital gain) to its investors before the end of its taxable year.

For an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the “95-percent income test”). In addition, at least 75 percent of its income generally must be from certain real estate sources (the “75-percent income test”), including rents from real property (as defined) and gain from the sale or other disposition of real property. Amounts received as impermissible “tenant services income” are not treated as rents from real property.<sup>663</sup> In general, such amounts are for services rendered to tenants that are not “customarily furnished” in connection with the rental of real property. In addition, at least 75 percent of the value of its total assets must be represented by real estate assets, cash and cash items (including receivables), and government securities, and maximum percentages apply to ownership of other types of securities (the “asset test”).

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<sup>661</sup> H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1066.

<sup>662</sup> The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added section 7704(g), permitting electing 1987 partnerships not to be subject to the general rule treating publicly traded partnerships as corporations and to be subject to an additional tax.

<sup>663</sup> A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

## **Accuracy-related penalties**

An accuracy-related penalty of 20 percent is imposed under section 6662 on the portion of any underpayment of tax attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.<sup>664</sup> An understatement of income tax is the excess of the amount of tax properly required to be shown on a return over the amount actually shown on the return, subject to certain reductions.<sup>665</sup> An understatement is substantial for a noncorporate taxpayer if the amount of the understatement exceeds the greater of (1) 10 percent of the correct tax liability or (2) \$5,000.<sup>666</sup> For corporate taxpayers an understatement is substantial if it exceeds the lesser of (1) 10 percent of the correct tax liability (or \$10,000 if greater) or (2) \$10,000,000.<sup>667</sup>

Similarly, section 6662A imposes a 20-percent penalty on reportable transaction understatements, that is, understatements involving listed transactions or any reportable transaction (other than a listed transaction) if a significant purpose of the transaction is the avoidance or evasion of Federal income tax.<sup>668</sup> The penalty rate is increased to 30 percent for transactions subject to 6662A which are not adequately disclosed in accordance with section 6011 and the regulations promulgated thereunder.<sup>669</sup>

The section 6662 accuracy-related penalty is not imposed on an underpayment (or portion thereof) if the taxpayer demonstrates a reasonable cause for the underpayment and the taxpayer acted in good faith.<sup>670</sup> The section 6662A reportable transaction understatement penalty is subject to a more stringent reasonable cause exception (commonly referred to as the “strengthened reasonable cause exception”). In addition to demonstrating reasonable cause and good faith, to avoid application of the section 6662A penalty a taxpayer must demonstrate (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011, (2) that there is or was substantial authority for such treatment, and (3) reasonable belief that such treatment was more likely than not the proper treatment. A reasonable belief must be based on the facts and law as they exist at the time that the return in question is filed and must relate solely to the taxpayer’s chances of success on the merits of the treatment.<sup>671</sup>

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<sup>664</sup> Sec. 6662. The penalty rate is increased to 40 percent for gross valuation misstatements. Sec. 6662(h).

<sup>665</sup> Sec. 6662(d)(2). An understatement is generally reduced by amounts attributable to (1) positions for which the taxpayer has substantial authority, or (2) items adequately disclosed and for which the taxpayer has a reasonable basis. The reduction does not apply to tax shelter items.

<sup>666</sup> Sec. 6662(d)(1)(A).

<sup>667</sup> Sec. 6662(d)(1)(B).

<sup>668</sup> Sec. 6662A(b)(2).

<sup>669</sup> Sec. 6662A(c).

<sup>670</sup> Sec. 6664(c).

<sup>671</sup> Sec. 6664(d)(3).



Moreover, reliance on professional advice may support a taxpayer's reasonable belief only in certain circumstances.<sup>672</sup>

In addition, for transactions entered into after March 30, 2010, a strict liability penalty is imposed under section 6662 for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in section 7701(o), or failing to meet the requirements of any similar rule of law. The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return).

### **Explanation of Provision**

#### **Partnership interests transferred in connection with the performance of services under section 83**

In the case of a transfer after the date of enactment of any interest in a partnership in connection with the provision of services to or for the benefit of the partnership, the bill provides for a determination of the fair market value of the partnership interest, and provides that the recipient of the partnership interest is deemed to have made the section 83(b) election unless the recipient affirmatively elects otherwise. Thus, absent such an election, a transferee of a partnership interest for services must include in income for the taxable year of the transfer the fair market value (if any) of the partnership interest.

For purposes of section 83, the fair market value of the partnership interest is generally its liquidation value; that is, specifically, the fair market value is deemed to be the amount the partner would receive if, at the time of transfer of the partnership interest, the partnership had sold all its assets at fair market value and distributed the proceeds (reduced by partnership liabilities) to the partners in liquidation of the partnership.

#### **Recharacterization as ordinary income**

The provision generally treats net income from an investment services partnership interest as ordinary income except to the extent it is attributable to the partner's qualified capital interest. Thus, the provision recharacterizes the 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 rates and is subject to self-employment tax.

Net income means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year. All items of income, gain, deduction, and loss that are taken into account in computing net

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<sup>672</sup> Section 6664(d)(3)(B) does not allow a reasonable belief to be based on a "disqualified opinion" or on an opinion from a "disqualified tax advisor."

income (or net loss) are treated as ordinary income (or ordinary loss, as the case may be). Any dividend taken into account in determining net income or net loss is not treated as qualified dividend income for purposes of the section 1(h) rule taxing dividends at capital gains rates.

### **Definition of investment services partnership interest**

#### **In general**

The provision provides that an investment services partnership interest is a partnership interest held (directly or indirectly) by any person if it was reasonably expected (at the time the person acquired the partnership interest) that the person (or any related person) would provide, or already has provided, (directly or indirectly) a substantial quantity of certain services with respect to assets held (directly or indirectly) by the partnership. The services are (1) advising as to the advisability of investing in, purchasing, or selling any specified asset, (2) managing, acquiring, or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets, and (4) any activity in support of any of the foregoing services. Activities in support of these services are intended to include supervising others who perform the services as well as assisting others who perform the services.

#### **Specified assets**

For this purpose, specified assets means securities (as defined in section 475(c)(2) without regard to the last sentence), real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), or options or derivative contracts with respect to such securities, real estate, partnership interests, or commodities. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A partnership interest includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a private equity fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.<sup>673</sup> For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm. A commodity for this purpose means a (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified.

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<sup>673</sup> It is intended that income from providing the services described above with respect to the business or assets of the partnership in which the partner (directly or indirectly) holds a partnership interest is subject to the recharacterization rule of the provision.

For purposes of this rule, assets held (directly or indirectly) by the partnership are considered to include assets held through any other entity, including a corporation. It is intended that the general rule not be avoided by means of arrangements through which a partner has the right to income or gains based on the performance of assets while taking the position that the partnership does not directly or indirectly hold the assets. Similarly, it is intended that the general rule not be avoided by disposing at capital gains rates (or on a tax-favored basis) of rights to receive income or gains based on the performance of assets. Treasury regulatory authority is provided to implement this intent. For example, such a disposition may be treated as giving rise to ordinary income under Treasury guidance under the provision (described below) relating to a disqualified interest in the form of a derivative instrument with respect to an entity.

A specified asset does not include a farm used for farming purposes that is held by a partnership, all of the interests in which are held (directly or indirectly) by members of the same family. Farming purposes include cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including animals) on a farm.<sup>674</sup> For this purpose, members of a family, with respect to an individual, include the individual's ancestor, spouse, and lineal descendant, as well as the lineal descendant of the individual's spouse or the individual's parent (e.g., the individual's siblings), along with the spouse of any of these lineal descendants. For example, assume that a farm used for farming purposes is owned by a partnership whose partners are the adult children (and their spouses) and grandchildren of an individual who farmed the land before his death. The farm is rented to a nonfamily member who uses it for farming purposes, and one of the children handles paperwork and any maintenance related to the rental agreement and collects the rent on behalf of the partnership. The farm is not a specified asset under the provision.

### Example

The provision does not apply to services other than those giving rise to an investment services partnership interest. For example, assume that three individuals form a partnership to operate a biotechnology business; two each contribute \$1 million in cash, and the third contributes his personal services as a research scientist. In the following year, the business profits of the partnership are \$300,000, and the partnership agreement provides that each of the three partner's distributive share is \$100,000. The profits are ordinary income to the partners under present law, so the provision does not affect the income tax rate applicable to the partners.<sup>675</sup> In the following year, the third partner (the research scientist) sells his partnership interest. Because the third partner's services do not consist of the investment management services described above, the gain on sale of the partnership interest is not subject to

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<sup>674</sup> As described in section 2032A(e)(5), for this purpose farming purposes also include (1) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one half of the commodity so treated, and (2) the planting, cultivating, caring for, or cutting of trees or the preparation (other than milling) of trees for market.

<sup>675</sup> The income generally is subject to self-employment tax under present law in the hands of a general partner, or a limited partner receiving guaranteed payments as remuneration for services, without regard to the provision.

recharacterization under the provision. As another example, assume instead that a partnership of three individuals is formed to manage investments in specified assets. The first two individuals contribute \$1 million each and the third contributes his personal services advising the partnership as to the advisability of investing in particular specified assets, and managing, acquiring, arranging financing for, and disposing of such assets. In the following year, the profits of the partnership are \$300,000, and the partnership agreement provides that each of the three partner's distributive share is \$100,000. Because the third partner's services consist of the services described above with respect to specified assets, the third partner's share of profits is subject to recharacterization under the provision. Similarly, if the third partner (the investment manager) later sells his partnership interest and recognizes gain, the gain is recharacterized as ordinary income under the provision.<sup>676</sup>

### **Exception for qualified capital interest**

#### **In general**

The provision provides an exception to recharacterization as ordinary income in the case of items of income, gain, loss, and deduction that are allocated to the portion of an investment services partnership interest that is a qualified capital interest, provided that allocation requirements are met. In general, the exception to recharacterization for qualified capital interests of service providers is intended to apply to capital invested in the partnership by the service provider if the investment is made on the same terms as investments of capital by partners not providing services.

#### **Allocation requirements relating to qualified capital interests**

The allocation requirements are met if (1) items are allocated to the service providing partner's qualified capital interest in the same manner as the items are allocated to other qualified capital interests of partners that do not provide any of the identified investment management services and that are not related to the service-providing partner, and (2) the allocations made to the qualified capital interests of unrelated nonservice providing partners are significant compared to the allocations made to the service providing partner's qualified capital interest.

Items allocated among the partners in proportion to each partner's qualified capital interest may be considered as allocated in the same manner, under this rule, if the qualified capital interests to which the allocations are made are substantially identical as to the degree of risk and with respect to all other economically significant aspects, benefits and burdens. For example, items are not allocated in the same manner under this rule if they are allocated in the same proportion to riskier interests and to safer interests. Similarly, items are not considered to be allocated in the same manner under this rule if allocations to qualified capital interests of nonservice providing partners are artificially high while returns that are below market, or artificially low, are made to other types of interests (for example, debt) held by the nonservice providing partners.

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<sup>676</sup> The rule providing that gain is treated as ordinary income on the disposition of an investment services partnership interest is described below.

### Example

For example, assume that a partnership that is a private equity fund has several types of interests, one class of which is issued as “units” on the same date at \$1 million for each unit. The partnership issues no debt. A partner (that is itself a partnership of individuals who provide services) that will provide investment management services with respect to specified assets of the fund acquires one unit and contributes \$1 million to the partnership. The partnership agreement also provides for a carried interest for the service provider equal to 20 percent of profits (subject to a hurdle rate and other conditions), as well as a fee determined as two percent of the total capital committed to the fund per year. Eleven other partners that are not related to the service partner each acquire nine \$1 million units, thereby contributing \$9 million each. The level and type of risk, rate of return, rights to cash or property distributions during partnership operations and on liquidation, and other economic rights, are identical with respect to each of the 100 units of this class of interests in the partnership. In this situation, the requirements for the exception from recharacterization of the service partner’s income from the partnership are met with respect to its unit, because the service partner holds a qualified capital interest of \$1 million and allocations are made to the service partner’s qualified capital interest in the same manner as to other non-service providing, unrelated partners’ qualified capital interests, and the allocations made to such other partners’ qualified capital interests are significant compared to the allocations made to the service providing partner’s qualified capital interest. Amounts allocated to the service provider pursuant to its carried interest (i.e., its right to 20 percent of profits), by contrast, are subject to recharacterization as ordinary income under the general rule of the provision.

### Regulatory authority with respect to allocations to qualified capital interests

In addition to regulatory authority to carry out the purposes of the provision in other respects, specific regulatory authority is provided in the context of qualified capital interests to provide exceptions to the allocation requirements.

To the extent provided in Treasury regulations or guidance, the allocation requirements of the provision may be applied separately with respect to a portion of a qualified capital interest. This regulatory authority is intended to apply in situations in which a clearly separable portion of the service provider’s qualified capital interest satisfies the allocation requirements, but another portion either does not satisfy the allocation requirements, or it is not clear whether the other portion can satisfy the allocation requirements.

Example.—Assume the facts of the foregoing example. After four years, the service partner purchases from the partnership for \$3 million a different class of partnership interest (a class B interest) that is not available to nonservice providing partners and that provides for a preferred return. The \$3 million contribution increases the service partner’s qualified capital interest by \$3 million. No other partner has the combination of allocations similar to those held by the service partner, that is, allocations attributable to a partnership unit plus a preferred return on a class B interest. This regulatory authority could appropriately be implemented to provide that the exception from recharacterization applies separately to the portion of the allocations to the partner’s qualified capital interest that relate to his unit, but not to the class B interest, because allocations of partnership items are made to the unit portion of the service provider’s qualified capital interest in the same manner as such allocations are made to other units held by

unrelated partners that do not provide services. It is not, however, consistent with the purposes of the provision for guidance to provide that the preferred return in such a case constitutes a return on a qualified capital interest that is not recharacterized as ordinary, because under the economic arrangements among the partners, the portion of the service provider's qualified capital interest attributable to the class B interest is not invested on the same terms and in the same manner as qualified capital interests of unrelated nonservice providers.

To the extent provided in Treasury regulations or guidance, an exception to the allocation requirements may be provided in cases in which the requirement relating to significance of the allocations to nonservice providers is not met, but it is possible to ensure in guidance that the items are allocated to the qualified capital interests of service providers consistently with the purposes of the general rule. If these conditions are met, then under the regulations or guidance, items of partnership income, gain, loss, and deduction are not taken into account under the general rule recharacterizing income as ordinary. It is appropriate to provide such guidance in the case in which all of the partners of a partnership are service providers so there are no significant allocations to unrelated nonservice providers. It is anticipated that in the case in which all of the partners provide substantial investment management services, Treasury guidance may provide that pro rata allocation of partnership items to qualified capital interests is consistent with the purposes of the general rule, and may provide that a portion of such items is not recharacterized as ordinary income. Treasury guidance might also provide that a portion of the pro rata return to qualified capital interests is a reasonable return on capital and that the excess is recharacterized as ordinary income. It is anticipated that the Treasury guidance will take into account whether the partnership agreement provides for proper allocation of the items among the partners and, with respect to a service provider, as between the partner's qualified capital interest and the remainder of the partner's interest in the partnership.

To the extent provided in Treasury regulations or guidance, allocations are not treated as failing to meet the allocation requirements solely because the allocations to the qualified capital interest of the partner holding an investment services partnership interest constitute a lower return on investment than the allocations made to qualified capital interests of unrelated nonservice providing partners. For example, guidance under this authority is appropriate if allocations throughout the term of the partnership are lower to the service providing partner's qualified capital interest than to nonservice providing partners' qualified capital interests. This could arise, for example, because throughout the term of the partnership, nonservice providing partners are allocated a preferred return on their capital to which the service providing partner is not entitled. It is not intended that the guidance treat transitory or temporary lower returns as meeting the allocation requirements if allocations to the service providing partner could reasonably be anticipated to be higher overall, or higher at a future point in the partnership's term. For example, it is not intended that guidance treat the allocation requirements as satisfied if, under the economic arrangements among the partners, initial allocations of income or profit to the service providing partner are lower than to other partners (for example, during the period in which the other partners recoup capital), and then following the satisfaction of conditions (such as return of capital to investor partners, meeting a hurdle rate, the passage of a number of years, or other conditions), the allocations of income or profit to the service providing partner are substantially higher than to other partners. Similarly, it is not intended that guidance treat the allocation requirements as satisfied if the overall allocations of income and gain to the service

providing partner are reasonably expected to be higher than to other partners over the life of the partnership or over a substantial period or aspect of partnership activity.

#### Tiered partnerships

The provision provides a rule governing allocations to qualified capital interests in the situation of tiered partnerships. Except as otherwise provided in Treasury guidance or regulations, partnership items that are allocated to qualified capital interests in a lower-tier partnership are treated as satisfying the allocation requirements (and thus are not recharacterized as ordinary) when allocated by any upper-tier partnership, provided that (1) at the relevant lower tier, the allocation requirements are met (i.e., the allocations to the service provider's qualified capital interest are made in the same manner that such allocations are made to qualified capital interests of unrelated nonservice providing partners and the allocations to the nonservice providing partners are significant compared to those made to that service provider's qualified capital interest), and (2) the items are allocated on the basis of the partners' qualified capital interests in the relevant upper-tier partnership.

#### Carry and management fees are not self-charged

Allocations to a service provider's qualified capital interest do not fail to satisfy the allocation requirements solely because they do not reflect the share of the cost of services provided by the service provider with respect to the service provider's own qualified capital interest, except as otherwise provided in Treasury regulations or guidance. This rule is intended to address the situation in which the manager does not charge itself a carry, for example, so that allocations to the manager's qualified capital interest are unreduced by that pro rata portion of the carry whereas allocations to unrelated nonservice providing partners' qualified capital interests are reduced by their pro rata portion of the carry. Similarly, it is intended that the rule address the situation in which the manager does not charge itself a fee with respect to its own qualified capital interest, resulting in a higher income or profit allocation with respect to the manager's qualified capital interest to that extent, because the manager is not allocated the comparable share of the deduction for the fee it charges the partnership, a pro rata portion of the deduction for which is reflected in the allocations to the unrelated nonservice providing partners. It is intended that this rule be applied narrowly.

Example.—Assume that a partnership that is a private equity fund has investor partners who commit to contribute \$70 million and a manager partner who contributes \$30 million in cash. The partnership agreement provides for a 20 percent carried interest for the manager partner, but provides that the manager waives the carry with respect to its own capital contribution of \$30 million. After calling all committed capital, the fund invests \$100 million. The investor partners' qualified capital interests total \$70 million, and the manager's qualified capital interest is \$30 million. Assume that other than the waiver of carry, allocations with respect to the manager's qualified capital interest satisfy the requirements of 710(d)(1). After five years, the fund sells an investment and realizes a gain of \$20 million. Pursuant to the partnership agreement, the gain is initially allocated to each partner according to invested capital, \$14 million to the investor partners in aggregate (that is, \$20 million times 70 percent) and \$6 million to the manager partner (that is, \$20 million times 30 percent). With respect to the investor partners, 80 percent of the initially allocated amount is allocated to them (that is, \$11.2

million), a 16 percent return on their qualified capital interests, and the other 20 percent (\$2.8 million) is allocated to the manager partner in respect of the carried interest. With respect to the manager's interest, no carried interest is charged and the entire \$6 million is allocated to it, a 20 percent return on the manager's qualified capital interest. In total, the manager partner is allocated \$8.8 million (\$6 million plus \$2.8 million). In this situation, it is not intended that all amounts allocated to the manager are recharacterized merely because the manager's interest is not charged a carry. Except as otherwise provided in Treasury regulations, the \$6 million allocation to the service provider satisfies the allocation requirement that amounts be allocated in the same manner to service providers and to unrelated nonservice providers, because the difference in the rate of return (16 versus 20 percent) is attributable solely to the waiver of carry on the manager's qualified capital interest. The other \$2.8 million allocated to the manager is recharacterized as ordinary income under the provision.

#### Definition of qualified capital interest

A qualified capital interest means the amount of a partner's interest in partnership capital attributable to (1) the fair market value of money or other property contributed by the partner to the partnership in exchange for the partnership interest (determined without regard to the deemed contribution rules of section 752(a), and without regard to any other deemed contribution), (2) the amount included in the partner's gross income under section 83 with respect to the transfer of the partnership interest by the partnership for services, and (3) the partner's distributive share of cumulative net income and gain of the partnership included in the partner's income, if any, that has not been distributed by the partnership. The qualified capital interest is reduced by partnership distributions to the partner, and by the partner's share of partnership losses, if any.

A qualified capital interest takes into account these amounts for taxable years prior to those to which the provision applies (as well as for years to which the provision applies). It is intended that an amount of prior-year qualified capital interest be documented by adequate contemporaneous records. For example, adequate contemporaneous records may include prior-year Schedule K-1s provided to the partner by the partnership, or other contemporaneous records that the Treasury Department in guidance provides are appropriate.

In the case of the transfer of an investment services partnership interest in a fully taxable transaction, the transferee partner accedes to the amount of the qualified capital account of the transferor partner. Unlike the basis rules of section 743 in the case of a transfer of a partnership interest, only the amount of the transferor's qualified capital interest is treated as the transferee's qualified capital interest. A qualified capital interest does not include any amount paid to a person other than the partnership; for example, such an interest does not include the price of a partnership interest acquired by purchase from another partner. It is intended that rules similar to the rules of section 197(f)(9) apply to the transfer of an investment services partnership interest.

To prevent double-counting of amounts as qualified capital interests when allocations are made with respect to contributed property under section 704(c), proper adjustments are required to be made to the amount of the qualified capital interest to take into account any difference resulting from the contribution of property to the partnership by a partner of property whose fair market value is not equal to its adjusted basis immediately before the contribution. For example, if the fair market value of the property is greater than the adjusted basis of the property



immediately before the contribution, it is intended that adjustments reducing the qualified capital account are to be made in a manner similar to the adjustments made under 704(c) when appreciated property is contributed (a “forward” 704(c) transaction).

The amount of a qualified capital interest includes the fair market value of a partnership interest that becomes an investment services partnership interest by reason of a change in services with respect to assets held (directly or indirectly) by the partnership. In this situation, the partnership interest is treated as an investment services partnership interest notwithstanding the requirement that an investment services partnership interest generally includes a partnership interest held by a person if it was reasonably expected (at the time that the person acquired the interest) that the person would provide a substantial quantity of investment management services. For example, assume that a partnership is formed to provide investment advice for a fee. Later, the partnership acquires specified assets and the partners provide investment management services with respect to these assets, causing their partnership interests to become investment services partnership interests. The amount of each of the partners’ qualified capital interests is equal to the fair market value of each of their partnership interests immediately before the change in service.

#### Loans, advances, guarantees

For purposes of the exception for qualified capital interests, an investment services partnership interest is not treated as acquired by contribution of capital by a service providing partner to the extent of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or by a person related to that other partner or the partnership). For example, if partner A loans partner B funds that partner B contributes to the partnership, the loaned amount is not a qualified capital interest of partner B.

In addition, any loan or other advance to the partnership made or guaranteed, directly or indirectly by a partner not providing services to the partnership is treated as the qualified capital interest of that partner, for purposes of determining the amount of the service-providing partner’s qualified capital interest, as well as for purposes of determining whether allocations to other partners’ qualified capital interests are significant (but not, however, for purposes of determining whether allocations are made in the same manner to other partners’ qualified capital interests as to the service provider’s). Income and loss treated as allocable to qualified capital interests of partners are adjusted accordingly.

For example, if investor partners in a private equity fund that is a partnership contribute capital primarily as debt rather than as equity, while the manager of the fund contributes only equity so that his capital interest appears to be a large percentage of the total equity contributed, the provision treats the partnership debt to the investors as the investors’ capital interests for this purpose. The percentage of total capital interests that is attributable to the fund manager in this example is determined taking into account this debt as well as the equity contributed to the fund, so the manager’s capital interest is a smaller percentage of total capital interests than if only equity contributions were taken into account.

It is intended that an individual general partner’s qualified capital interest take into account the value of certain property in the following specific circumstances. The individual

general partner provides management services and holds an investment services partnership interest in a partnership. The partnership borrows on a fully recourse basis from an unrelated third party bank. The individual general partner unconditionally guarantees the loan, also on a fully recourse basis, and puts up his home as collateral for the loan. Later the partnership defaults on the debt and, pursuant to its terms, the bank forecloses on the home in satisfaction of the debt. In this situation, the fair market value of the foreclosed home at the time of foreclosure (up to the amount of the partnership debt satisfied in the foreclosure) is included in the general partner's qualified capital interest at the time that the debt is satisfied by foreclosure on the home.

### **Losses, dispositions, and partnership distributions**

#### **In general**

The provision provides rules for the treatment of losses with respect to an investment services partnership interest, as well as rules for the disposition of all or a portion of such a partnership interest, and rules for distributions of partnership property with respect to such a partnership interest.

#### **Losses**

Consistent with the general rule providing that net income with respect to an investment services partnership interest is ordinary income, the provision provides that net loss with respect to such a partnership interest (to the extent not disallowed) generally is treated as ordinary loss. For this purpose, net loss means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year. The net loss is allowed for a partnership taxable year, however, only to the extent that the loss does not exceed the excess (if any) of (1) aggregate net income with respect to the partnership interest for prior partnership taxable years to which the provision applies, over (2) the aggregate net loss with respect to the partnership interest not disallowed for prior partnership years to which the provision applies. Any net loss that is not allowed for the partnership taxable year is carried forward to the next partnership taxable year.

Notwithstanding the present-law rule that the basis of a partnership interest generally is reduced by the partner's distributive share of partnership losses and deductions,<sup>677</sup> the provision provides that no adjustment is made to the basis of a partnership interest on account of a net loss that is not allowed for the partnership taxable year. When any such net loss that is carried forward is allowed in a subsequent year, the adjustment is made to the basis of the partnership interest.

For purposes of determining self-employment tax, a net loss from an investment services partnership interest (to the extent it is allowed in computing taxable income) is taken into

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<sup>677</sup> Sec. 705(a)(2).

account in determining net earnings from self-employment for the taxable year. Thus, for example, if an individual has three investment services partnership interests, two of which generate net income for the taxable year and the third of which generates a net loss that is allowable under the provision as an ordinary loss for the taxable year, then the entire net income and net loss are taken into account in determining the individual's net earnings from self-employment for the taxable year. However, to the extent a loss is disallowed under this provision for a taxable year, that loss does not reduce the taxpayer's net earnings from self-employment for that taxable year, but is taken into account in the carryover year for which it is allowed in determining the amount of ordinary income under this provision. To the same extent as under present law, the provision does not permit net operating loss deductions in calculating net earnings from self-employment.<sup>678</sup>

### Dispositions

On the disposition of an investment services partnership interest, gain (other than that attributable to the partner's qualified capital interest) is treated as ordinary income, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest generally is considered as capital gain or loss,<sup>679</sup> except as specifically provided under the bill in the case of the sale or exchange of certain publicly traded partnership interests. Gain on the disposition of an investment services partnership interest is recognized notwithstanding any other income tax provision, such as nonrecognition or deferral rules, except as otherwise specifically provided in the bill in the case of a contribution governed by section 721 of an investment services partnership interest to a partnership in exchange for an interest in that partnership. Loss on the disposition of an investment services partnership interest is treated as ordinary loss, but only to the extent of the amount by which aggregate net income previously treated as ordinary under the provision exceeds aggregate net loss previously allowed as ordinary under the provision.

The amount of net loss that otherwise (but for the rule providing for no basis reduction described above) would have reduced the basis of the investment services partnership interest is disregarded for purposes of the provision, in the event of a disposition of the interest. For example, this rule applies if a partner disposes of a portion of an investment services partnership interest with respect to which losses are disallowed, because when the interest is disposed of, net losses exceed net income from the interest cumulatively for all years to which the provision applies. In this situation, the amount of net loss that otherwise (but for the rule providing for no basis reduction described above) would have reduced the basis of the interest is not allowed against subsequent income or gain from the interest.

On the disposition of an investment services partnership interest, any portion of which is a qualified capital interest, the provision provides that a proportionate amount of the gain or loss

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<sup>678</sup> Sec. 1402(a)(4).

<sup>679</sup> Sec. 741; except ordinary treatment applies to the extent gain is attributable to inventory and unrealized receivables under section 751(a). The bill adds investment services partnership interests to this category under section 751.

on disposition is not subject to recharacterization as ordinary. Under this rule, the proportionate amount of gain or loss not treated as ordinary is determined by the ratio of (1) the distributive share of gain or loss that would have been allocated to the qualified capital interest in a manner satisfying the allocation requirements of section 701(d)(1), had the partnership sold all its property in a fully taxable transaction for cash in an amount equal to the fair market value of the property immediately before the disposition, to (2) the distributive share of gain or loss that would have been so allocated to the entire investment services partnership interest of which the qualified capital interest is a part.

For example, a partner sells his investment services partnership interest for a gain of \$100. A portion of the interest is a qualified capital interest (meeting the applicable definitional requirements), allocations are made to the qualified capital interest in the same manner as they are made to qualified capital interests of unrelated nonservice providing partners, and those allocations are significant compared to the allocations made to the disposing partner's qualified capital interest, so that the allocation requirements of section 710(d)(1) are met. If the partnership were to sell all its property in a fully taxable transaction for cash in an amount equal to the fair market value of the property immediately before the disposition of the investment services partnership interest, gain allocable to the selling partner's qualified capital interest would be \$80, and gain allocable to the selling partner's entire investment services partnership interest would be \$400, a ratio of 20 percent. Thus, the proportionate amount of the \$100 gain that is not subject to recharacterization as ordinary income is \$20.

Gain or loss is not treated as ordinary, however, in the case of the disposition by an individual of an investment services partnership interest that is an interest in a publicly traded partnership (as defined in section 7704) if neither the individual nor a member of the individual's family at any time provided any of the described investment management services with respect to assets held directly or indirectly by the publicly traded partnership. For this purpose, an individual's family includes his or her spouse, parents, children, and grandchildren, as specified in section 318(a)(1). For example, if an investor who has never performed investment management services with respect to assets held directly or indirectly by the publicly traded partnership (and whose family members have not performed such services with respect to such assets) sells his or her publicly traded partnership interest on an exchange, the gain or loss from the sale is not treated as ordinary by reason of the general recharacterization rule of the provision, even though a related party (other than a family member) may have performed investment management services with respect to such assets. To the extent of his or her share of partnership inventory items (including any investment services partnership interests held by the publicly traded partnership) and other "hot assets" of the partnership to which section 751(a) applies, if any, however, a portion of the gain is ordinary. No inference is intended that an individual who does not provide investment management services has an investment services partnership interest merely because the partnership itself or a lower tier partnership provides investment management services.

The rule that gain or loss on a disposition of an investment services partnership interest is recognized notwithstanding nonrecognition rules, however, does not apply in the case of the contribution of the interest to a partnership in a transaction governed by the nonrecognition rule of section 721, provided other requirements are met. The taxpayer must make an irrevocable election to treat the interest received in the section 721 exchange as an investment services

partnership interest, and must comply with reporting and recordkeeping requirements as required by the Treasury Department. Under this rule, the partnership interest received in the exchange thereafter gives rise to income, gain, and loss subject to the rules of the provision as if the taxpayer were providing the investment management services with respect to assets of the partnership, and the amount of the transferor's qualified capital interest (if any) is treated as the transferee's qualified capital interest.<sup>680</sup> Thus, for example, the contribution of an investment services partnership interest to another partnership in exchange for an interest in that partnership (for example, the contribution of partnership interests to an operating partnership of an UPREIT or a partnership rollup) remains a nonrecognition transaction governed by section 721 if this election is made, provided that section 721 otherwise applies to the transaction.

### Partnership distributions

On the distribution of property by a partnership to a partner with respect to an investment services partnership interest, the provision generally provides that the partner recognizes ordinary income to the extent of any built-in gain in the property. The partner also recognizes gain to the extent the value of the distributed property exceeds the partner's basis in its partnership interest.

Specifically, the provision provides that the excess (if any) of the fair market value of the property at the time of the distribution over the adjusted basis of the distributed property in the hands of the partnership is taken into account as an increase in the partner's share of the taxable income of the partnership. As a result, it is included in income by the partner, and is recharacterized as ordinary income by reason of the general rule of the provision (new section 710(a)(1)). This amount is not so includable to the extent otherwise taken into account in computing the taxable income of the partnership. For example, the rules of section 704(c)(1)(A) and (B) continue to apply so that amounts are shared among the partners so as to allocate precontribution gain to the contributing partner in the case of the distribution of previously contributed appreciated property. It is not intended that precontribution gain or loss be included duplicatively, nor that such amounts be allocated away from the contributing partner by reason of this provision.

To the extent the fair market value of the property (which is treated as money) exceeds the partner's adjusted basis in its partnership interest, the partner has ordinary income (by reason of section 731(a)(1) and new section 710(a)(1)). The basis of the distributed property is its fair market value at the time of the distribution. The adjusted basis of the distributee partner's interest in the partnership is reduced (but not below zero) under section 733 by the amount of money upon the distribution.

For example, assume a partnership has an adjusted basis of \$20 in a property whose fair market value is \$50. The partnership agreement provides for allocations that are compliant with section 704(c). The partnership distributes the property to a partner whose investment services

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<sup>680</sup> It is not intended that built-in gain or loss, if any, with respect to the interest surrendered in the exchange be locked in or fixed at the time of the exchange, but rather, that the interest received in the exchange be treated as an investment services partnership interest in all respects.

partnership interest has an adjusted basis of \$10. Under the provision, \$30 (\$50 minus \$20) is taken into account by the partner as an increase in his share of partnership taxable income. Under the general rule in new section 710(a), this amount is treated as ordinary income. The partner's basis in his investment services partnership interest is increased from \$10 to \$40 by the \$30 of income taken into account and then reduced to 0 by \$40 of the \$50 value of the property distributed. Because the fair market value of the distributed property exceeds the basis of the partnership interest by \$10 in this case, the partner includes the \$10 as ordinary income as well. The basis of the distributed property in the partner's hands is \$50. If the partner sells the partnership interest at a gain, the gain is treated as ordinary income under the general rule of the provision (new section 710(a)).

So that the other partners' shares of the basis of partnership property are not affected by the property distribution, the present-law rules providing for an adjustment to the basis of the partnership's property in the event of a section 754 election or a substantial basis reduction are applied without regard to the income inclusion rule for property distributions with respect to an investment services partnership interest.

In applying the present-law rules relating to ordinary income treatment of amounts attributable to unrealized receivables and inventory items on sale or exchange of a partnership interest (sec. 751), an investment services partnership interest is treated as an inventory item of the partnership. Thus, for example, upon the sale or exchange of an interest in a partnership that in turn holds an investment services partnership interest, amounts received by the transferor partner that are attributable to the investment services partnership interest are considered as ordinary income under section 751(a). A similar result applies in a distribution treated as a sale or exchange under section 751(b).

In the case of a distribution of a partnership interest in connection with the contribution (or deemed contribution) of property to a partnership to which section 721 applies pursuant to a partnership merger, division, or technical termination, however, the rules treating a distribution of partnership property as a recognition event and as a distribution of money do not apply, if the partner elects to treat the partnership interest received as an investment services partnership interest and complies with reporting and recordkeeping requirements mandated by the Treasury Department.

### **Other entities**

The provision also recharacterizes as ordinary income the income or gain with respect to certain other interests, including interests in entities that are held by a person who performs, directly or indirectly, investment management services for the entity.

This rule applies if (1) a person performs (directly or indirectly) investment management services for any entity, (2) the person holds a disqualified interest with respect to the entity, and (3) the value of the interest (or payments thereunder) is substantially related to the amount of realized or unrealized income or gain from the assets with respect to which the investment management services are performed. In this case, any income or gain with respect to the interest is treated as ordinary income. Rules similar to the rules governing treatment of dividends as not eligible to be qualified dividends taxed at capital gains rates, and similar to the rules providing an

exception for a partner's qualified capital interest, apply for this purpose. For this purpose, a disqualified interest in an entity means (1) any interest other than debt, (2) convertible or contingent debt, (3) an option or other right to acquire either of the foregoing, or (4) a derivative instrument entered into (directly or indirectly) with the entity or an investor in the entity. A disqualified interest does not include a partnership interest. However, an option to acquire a partnership interest may be a disqualified interest. A disqualified interest also does not include, except as provided otherwise in Treasury regulations or guidance, stock in an S corporation or stock in a taxable corporation, which for this purpose means either a domestic C corporation or a foreign corporation, substantially all of the income of which is effectively connected with the conduct of a trade or business in the United States, or that is subject to a comprehensive foreign income tax. It is not intended that the exception for stock in an S corporation or domestic C corporation permit avoidance of the general rule relating to partnership interests through establishment of economically similar arrangements. Under this rule, a comprehensive income tax means the income tax of a foreign country if the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between that country and the United States, or if the corporation demonstrates to the satisfaction of the Treasury Secretary that the foreign country has a comprehensive income tax.

For example, if a hedge fund manager holds stock of a Cayman Islands corporation that in turn is a partner in a hedge fund partnership, the manager performs investment management services for the hedge fund, and the value of the stock (or dividends) is substantially related to the growth and income in hedge fund assets for which the manager provides investment management services, then gain in the value of the stock, and dividends, are treated as ordinary income for the performance of services. The fact that the services are performed for the hedge fund, rather than directly for the Cayman Islands corporation in which the manager has a disqualified interest, does not change this result under the provision. Thus, the gain is not eligible for the capital gain tax rate but rather, both the gain and the dividend are subject to tax as ordinary income. The income is treated as net earnings from self-employment for purposes of the self-employment tax of the individual who performs the services. Though the amounts received may exceed the cap (imposed by reason of section 1402(b)) on the old-age, survivors, and disability insurance portion of the self-employment tax, the hospital insurance portion of the self-employment tax is not capped, and applies to the income.

### **Blended tax rate applicable to individuals**

A blended tax rate applies to individual taxpayers under the provision. This rule applies to items realized by individuals directly as well as to items realized by individuals through a passthrough entity or tiers of passthrough entities. The blended rate is determined by applying a percentage to amounts that would otherwise be subject to ordinary income tax rates by reason of recharacterization as ordinary under the provision.

Thus, the general rule recharacterizing income and loss as ordinary applies only to the applicable percentage of the net income or net loss. The amount that would (without regard to the blended rate rule) be treated as ordinary by reason of the provisions relating to dispositions of partnership interests, distributions of partnership property, and other income and gain in connection with investment management services, is the applicable percentage of that amount. For purposes of applying the general rule recharacterizing income and loss as ordinary, and the

rule relating to other income and gain, an apportionment rule applies. Under the apportionment rule, the aggregate amount treated as ordinary income for the taxable year is allocated ratably among the items of income, gain, loss, and deduction taken into account in determining the applicable percentage of the amount. For example, if income that is recharacterized as ordinary with respect to an investment services partnership interest includes items of long term capital gain, short term capital gain, interest income, and dividend income, then the applicable percentage of net gain or loss is allocated on a pro rata basis to each of these items. On the disposition of an investment services partnership interest, in the case of gain that would not be recognized but for the recognition rule of new section 710(b)(1)(B), only the applicable percentage of such gain that is recharacterized as ordinary is recognized.

The provision provides a rule coordinating the application of applicable percentages with the rule of new section 710(a)(2), which limits net loss treated as ordinary to the aggregate net income recharacterized as ordinary under the provision. Under this coordination rule, that limitation rule applies only with respect to the applicable percentage of net loss for the taxable year. In the case of a prior partnership taxable year to which the provision applies, only the applicable percentage of net income or net loss for a prior partnership taxable year is taken into account for that prior taxable year. The coordination rule also provides that any net loss carried forward to the succeeding partnership taxable year is taken into account under the blended rate rules without reduction under the blended rate rules, that is, without applying the applicable percentage again. Instead of being taken into account as an item of loss in that succeeding year, the net loss that is carried forward is treated as an increase in net loss or as a reduction in net income (including below zero), as the case may be. Furthermore, the net loss carried forward is taken into account only after the amount of the net loss or net income for the succeeding year has been determined (based on all other items) and has been limited to the applicable percentage. In addition, an apportionment rule applies to losses that is similar to the apportionment rule applicable to gains.

For example, assume that an individual has a \$100 net loss in 2011 from an investment services partnership interest, no portion of which is a qualified capital interest. Assume that there are no partnership items for prior years. Assume further that the loss would otherwise be a long term capital loss to the individual. Finally, assume the individual separately has a \$50 capital gain from the sale of stock held for investment in 2011. Sections 710(a)(1) and 710(g)(1) apply to recharacterize 50 percent (the applicable percentage) of the \$100 net loss from the investment services partnership interest as an ordinary loss. Thus, \$50 of the loss is treated as ordinary and is disallowed for 2011 by section 710(a)(2)(A) and is carried forward. The other \$50 is a capital loss, which the individual offsets against his \$50 capital gain from the sale of stock. The carryforward rule of new section 710(a)(2)(B) in combination with the coordination rule provides that the disallowed \$50 ordinary loss becomes an item of loss for 2012. The \$50 net loss carried forward is not limited to the applicable percentage in 2012.

In 2012, the individual has \$100 of long-term capital gain from the investment services partnership interest. The coordination rule provides that the \$50 net loss carried forward from 2011 is applied to reduce the 2012 net income attributable to the investment services partnership interest. This reduction is taken after the applicable percentage (50 percent) is applied to 2012 net income. Thus, 50 percent, or \$50, of the 2012 net income of \$100 (an amount which does not include the loss carryover) is recharacterized as ordinary income. Then, the \$50 ordinary



loss carryover is allowed and reduces the \$50 of recharacterized ordinary income in year 2012 to zero. The result is that the carried forward 2011 loss offsets the applicable percentage of the 2012 income from the investment services partnership interest.

The rule that dividends taken into account in determining net income or net loss are not treated as qualified dividend income (for purposes of the section 1(h) rule taxing dividends at capital gains rates) applies only to the applicable percentage of dividends.

For taxable years to which the provision applies that begin before January 1, 2013, the applicable percentage is 50 percent. For taxable years beginning after December 31, 2012, the applicable percentage is 75 percent.

### **Underpayment penalty**

The provision provides that the accuracy-related penalty under section 6662 on underpayments applies to underpayments attributable to the failure to comply with section 710(d) (relating to the treatment of income in connection with investment management services involving disqualified interests) or the regulations under section 710(e) to prevent the avoidance of the purposes of section 710. The penalty rate is 40 percent. A strengthened reasonable cause exception similar to that applicable to reportable transaction understatements may apply with respect to the section 710(d) or (e) underpayments. The strengthened reasonable cause exception does not apply unless (1) the relevant facts affecting the tax treatment of the item are adequately disclosed, (2) there is or was substantial authority for the tax treatment, and (3) the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment. Rules similar to the rules of section 6664(d)(3) apply for purposes of determining reasonable belief.

### **Self-employment tax and Medicare unearned income tax**

#### **In general**

Under the provision, in the case of any individual who is engaged in the trade or business of performing the services described in new section 710(c)(1) with respect to any entity, any amount treated as ordinary income or loss from an investment services partnership interest is taken into account in determining the individual's self-employment tax. This rule applies notwithstanding other provisions of section 1402(a). It is intended that an entity include a partnership as well as an entity described in new section 710(d) or guidance thereunder. Because net income or gain from disposition of an investment services partnership is treated as ordinary income, the present-law exception under the self-employment tax rules for gain or loss from the sale or exchange of a capital asset does not apply, even though the net income from the investment service partnership interest might otherwise be characterized as capital gain. The provision applies notwithstanding the present-law special rule for limited partners under the self-employment tax, so the present-law exclusion for limited partners does not apply to the amount, if any, treated as ordinary income or loss from an investment services partnership interest under new section 710.

Amounts that are not treated as ordinary under the recharacterization rule of new section 710 because they are allocated to a qualified capital interest and meet the applicable

requirements under that rule are not taken into account in determining net earnings from self-employment (unless another provision of law requires them to be so taken into account).<sup>681</sup>

Income or loss that is treated as ordinary by reason of an investment services partnership interest held directly or indirectly by a publicly traded partnership is not subject to self-employment tax in the hands of an individual holder of such a publicly traded partnership interest who is not engaged in the trade or business of performing investment management services described in section 710 (c)(1) with respect to assets held directly or indirectly by the publicly traded partnership. Gain or loss on the disposition of a publicly traded partnership interest held by an individual is not subject to self-employment tax under the provision if the individual (or a family member)<sup>682</sup> has never provided the specified investment management services with respect to assets held directly or indirectly by the publicly traded partnership.

As provided under present law, for purposes of the Medicare unearned income tax,<sup>683</sup> in the case of a partnership holding assets for investment, each partner's distributive share of items of income, gain, or loss taken into account under section 702 is taken into account in determining the net investment income of the individual partner regardless of whether the partner is in the trade or business of providing the services specified in new section 710(c)(1) with respect to assets held (directly or indirectly) by the partnership. Thus, for example, assume that an individual provides investment management services. The individual holds an investment services partnership interest in a partnership that, in turn, holds a partnership interest in, and serves as the manager of the investments of, a private equity fund partnership. The individual partner's distributive share of the fund's interest, dividends, annuities, royalties, rents, and gains is taken into account in determining his or her Medicare unearned income tax. Items that are recharacterized as ordinary income under new section 710(a) and are subject to the SECA tax are not subject to the Medicare unearned income tax.

#### Application of blended rate

Under the provision, only the applicable percentage of items is includable in net earnings from self-employment. For taxable years to which the provision applies that begin before January 1, 2013, the applicable percentage is 50 percent. For taxable years beginning after December 31, 2012, the applicable percentage is 75 percent.

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<sup>681</sup> Further described above is the rule providing that a net loss from an investment services partnership interest (to the extent it is allowed in computing taxable income) is taken into account in determining net earnings from self-employment for the taxable year.

<sup>682</sup> For this purpose, the members of an individual's family are his or her spouse, parents, children, and grandchildren as set forth in section 318(a)(1).

<sup>683</sup> Section 1411; net investment income for this purpose is defined in section 1411(c). Section 1411 is effective for remuneration received, and taxable years beginning after, December 31, 2012.

## **Rules relating to publicly traded partnerships**

The provision provides that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income of a publicly traded partnership for taxable years beginning on or after the date that is 10 years after the date of enactment. Thus, for example, for such a taxable year, if a publicly traded partnership holds a partnership interest that is an investment services partnership, the publicly traded partnership's income from that investment services partnership interest is not qualifying income for purposes of section 7704. A publicly traded partnership, more than 10 percent of whose gross income consists of income from an investment services partnership interest, is treated as a corporation for Federal tax purposes under section 7704.<sup>684</sup>

The rule that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income does not apply, however, in the case of qualifying income under section 7704(d)(1)(E) and so much of 7704(d)(1)(F) as relates to 7704(d)(1)(E). Thus, income and gains from exploration and other activities relating to oil, gas, other natural resources, and other items so described are not treated as other than qualifying income by reason of being recharacterized as ordinary income.

The provision provides a special rule for certain partnerships that are owned by publicly traded REITs and that meet specific requirements. Under the special rule, the general rule that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income of a publicly traded partnership does not apply, provided the following requirements are met. The requirements are: (1) the partnership is treated as publicly traded (under section 7704) solely because interests in the partnership are convertible into interests in a publicly traded REIT; (2) 50 percent or more of the capital and profits interests of the partnership are owned, directly or indirectly, at all times during the taxable year, by the REIT (taking into account attribution rules under section 267(c)); and (3) the partnership itself satisfies the REIT income and asset limitations under sections 856(c)(2), (3), and (4). Thus, for example, this special rule provides that a partnership is not treated as a corporation under section 7704 in an UPREIT structure in which a publicly traded REIT owns more than 50 percent of the capital and profits interests of the partnership, partnership interests held by persons other than the REIT are convertible into publicly traded REIT stock, and the partnership itself meets the income and asset limitations of the REIT rules under sections 856(c)(2), (3) and (4). For this purpose, if the partnership interest may be put to the REIT or the partnership for REIT stock, it is considered convertible into interests of the publicly traded REIT. It is not intended that convertibility of partnership interests into a class of publicly traded REIT stock that tracks the performance of particular partnership assets (such as assets of a type that, if held in excess, would cause the REIT asset or income limitations not to be satisfied), or performance of the partnership assets generally, satisfies this special rule; rather, it is intended that such a partnership does not meet the requirements of this special rule.

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<sup>684</sup> The present-law exception to corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income within the meaning of section 7704(c)(2), does not apply in such a case, because under the provision, net income from an investment services partnership interest is not qualifying income within the meaning of section 7704(c)(2).

The provision provides a special rule for partnerships owning certain other publicly traded partnerships (i.e., exchange-traded partnerships whose income is ordinary). The general rule that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income of a publicly traded partnership does not apply in the case of a partnership that meets two requirements: (1) substantially all of the partnership's assets are interests in other partnerships that are traded on an established securities market; and (2) substantially all of the partnership's income is ordinary income or section 1231 gain. For this purpose, partnership interests that are readily tradable on a secondary market (or the substantial equivalent thereof) do not qualify; only those that are traded on an established securities market (for example, the New York Stock Exchange) meet the requirement of the special rule. It is intended that a substantial portion of the equity of the partnership be so traded; for example, if less than a substantial portion of the interests of the partnership are traded on an established securities market, the requirement is not satisfied.

### **Regulatory authority**

The Treasury Department is directed to prescribe such regulations as are necessary or appropriate to carry out the purposes of new section 710, including regulations to provide modifications to the application of the provision (including treating related persons as not related to one another) to the extent such modification is consistent with the purposes of this section, to prevent the avoidance of the purposes of the provision, and to coordinate the provision with other provisions of Federal tax law. It is intended that Treasury guidance prescribe such reporting and recordkeeping requirements as are necessary to carry out the provision.

It is expected that guidance and regulations will, among other things, address the effects, if any, of the provision on whether income is U.S. or foreign source (or is sourced within a U.S. possession); how income is characterized for purposes of the foreign tax credit limitation rules; whether income is subject to tax by the United States by reason of sections 897 and 1445 (sale of U.S. real property) or is exempt from U.S. tax under section 892 (income of foreign governments); whether income is effectively connected with the conduct of a trade or business within the United States; and whether income is subject to current U.S. tax under the passive foreign investment company or subpart F rules.

The intent of the provision is generally not to change the result under these rules, to the extent that is consistent with not providing an opportunity to avoid the recharacterization of income as ordinary under the provision and not creating an opportunity for exclusion or deferral of otherwise includable amounts. Thus, in general, it is not intended that the recharacterization of items of income or loss as ordinary under the provision effect a change in the source of the items or cause the items to be treated as effectively connected with the conduct of a U.S. trade or business, if the items would not otherwise be so treated. This intent is to be carried out consistently with the purposes of the provision. For example, it is not intended that the provision be utilized to effect a recharacterization as untaxed foreign-source ordinary income from personal services the amount of any otherwise taxable (or withholdable) U.S.-source dividend, effectively connected income, U.S. real property gain, or similar income or of any otherwise taxable subpart F inclusion or passive foreign investment company inclusion.

It is not intended that solely the recharacterization of income as ordinary under the provision cause income of a REIT that otherwise meets the requirements of section 856(c)(2), (3), or (4) to fail to meet the requirements of those paragraphs. Likewise, it is not intended that solely the recharacterization of income as ordinary under the provision cause income of a regulated investment company (“RIC”) that otherwise meets the requirements of section 851(b) to fail to meet the requirements of that subsection.<sup>685</sup> Similarly, it is not intended that solely the recharacterization of income as ordinary under the provision cause income not otherwise treated as unrelated business income of an exempt organization to fail to meet provisions of section 512(b) that are otherwise satisfied.

It is not intended that income or loss characterized as ordinary under the provision be taken into account in determining net investment income for purposes of the investment interest limitation of section 163(d).

It is not intended that opportunities to avoid or defer income inclusion be created by the recharacterization of income or loss as ordinary under the provision.

It is not intended that that provision affect the ability of taxpayers to rely on guidance with respect to sections 409A and 457A as such guidance applies to a profits interest in a partnership, i.e., guidance permitting taxpayers to treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services, as not resulting in the deferral of compensation.<sup>686</sup>

### **Effective Date**

The provision relating to transfers of partnership interests under section 83 is effective for partnership interests transferred after the date of enactment.

The provision relating to income of partners for performing investment management services treated as ordinary income is effective generally for taxable years ending after December 31, 2010.

In the case of a partnership taxable year that includes December 31, 2010, the amount of net income determined for purposes of the general rule of the provision (section 710(a)) is treated as being the lesser of the net income for the entire partnership taxable year or the net income determined by taking into account only items attributable to the portion of the partnership taxable year that is after the date of enactment.

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<sup>685</sup> For example, capital gain of a RIC that is a business development company that is recharacterized as ordinary under the provision is not intended to fail to qualify under section 851(b) solely by reason of recharacterization under this provision. No inference is intended that a RIC (such as a RIC that is not a business development company) may engage in the activities that give rise to income or gain recharacterized as ordinary under the provision.

<sup>686</sup> Preamble to Treas. Reg. 1.409A, T.D. 9321, April 17, 2007, and IRS Notice 2005-1, Q&A 7 and IRS notice 2009-8, Q&A 2.

The provisions relating to dispositions of partnership interests and distributions of partnership property apply to dispositions and distributions after December 31, 2010.

The provision relating to other income and gain is effective on December 31, 2010.

The rule that income from an investment services partnership interest is not qualifying income of a publicly traded partnership under section 7704 applies to taxable years of the partnership beginning on or after the date that is 10 years after the date of enactment.

## **2. Employment tax treatment of professional service businesses (sec. 413 of the bill and 1402(m) of the Code)**

### **Present Law**

#### **In general**

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act (“FICA”).<sup>687</sup> A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act (“SECA”).<sup>688</sup>

#### **FICA**

The FICA tax has two components. Under the old-age, survivors, and disability insurance component (“OASDI”), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.<sup>689</sup> The amount of wages subject to this component is capped at \$106,800 for 2010. 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.

#### **SECA**

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at \$106,800 for 2010. 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

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<sup>687</sup> See Chapter 21 of the Code.

<sup>688</sup> Sec. 1401.

<sup>689</sup> Secs. 3101 and 3111.

deductions attributable to the trade or business that are allowed under the self-employment tax rules.<sup>690</sup> Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

### Unearned income Medicare contribution

For taxable years beginning after 2012, in the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed. 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 over the threshold amount.<sup>691</sup> 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.

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

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)).

For purposes of the provision, net investment income does not include amounts subject to SECA tax. Thus, for example, in the case of a partner, the tax does not apply to any item taken into account in determining self-employment income for the taxable year on which tax is imposed under the self-employment tax rules.

### S corporation shareholders

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<sup>690</sup> 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).

<sup>691</sup> The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

An S corporation is treated as a passthrough entity for Federal income tax purposes. Each shareholder takes into account and is subject to Federal income tax on the shareholder's pro rata share of the S corporation's income.<sup>692</sup>

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages from the S corporation.

A shareholder of an S corporation generally is not subject to FICA tax on amounts that are not wages, such as the shareholder's share of the S corporation's income. Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized by the taxpayer as other than wages. Case law has addressed the issue of whether amounts paid to shareholders of S corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.<sup>693</sup>

In cases addressing whether payments to an S corporation shareholder were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.<sup>694</sup> In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.<sup>695</sup> The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.<sup>696</sup> The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.<sup>697</sup>

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<sup>692</sup> Sec. 1366.

<sup>693</sup> See the discussion of case law in, e.g., Richard Winchester, *The Gap in the Employment Tax Gap*, 20 Stanford Law and Policy Review 127, 2009; James Parker and Claire Y. Nash, *Anticipate Close Inspection of Closely Held Company Pay Practices - Part I*, 80 Practical Tax Strategies 215, April 2008; *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

<sup>694</sup> *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, e.g., *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

<sup>695</sup> See, e.g., *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

<sup>696</sup> *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

<sup>697</sup> In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 (9th Cir. 2004) at 10-11, the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits



## **Partners**

A partnership is treated as a passthrough entity for Federal income tax purposes. Each partner includes in income its distributive share of partnership items of income, gain and loss.<sup>698</sup>

A partner's distributive share of partnership items is not treated as wages for FICA tax purposes. A partner who is an individual is subject to the SECA tax on his or her distributive share of trade or business income of the partnership. The net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rent, dividends, interest, and capital gains and losses, as described above<sup>699</sup>). This rule applies to individuals who are general partners.

An exclusion from SECA applies for limited partners of a partnership.<sup>700</sup> Specifically, 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.<sup>701</sup>

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

## **Explanation of Provision**

### **Treatment of S corporation shareholders**

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that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996). In determining whether compensation is reasonable, the U.S. Tax Court has applied the multi-factor test viewed through the lens of an independent investor where a case is appealable to a U.S. Court of Appeals which has neither adopted nor rejected the independent investor test. See *Chickie's and Pete's, Inc. v. Commissioner*, T.C. Memo. 2005-243, 90 T.C.M. 399 (2005), at footnote 9; *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 89 T.C.M. 1279 (2005).

<sup>698</sup> Secs. 701, 702.

<sup>699</sup> Sec. 1402(a).

<sup>700</sup> Sec. 1402(a)(13).

<sup>701</sup> In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules. Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997). These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. However, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

Under the provision, in the case of a disqualified S corporation, a shareholder who provides substantial services with respect to certain professional service businesses takes into account for SECA tax purposes his or her pro rata share of S corporation income or loss described in section 1366 that are attributable to the business.

As under the present-law self-employment tax rules in the case of a trade or business carried on by a partnership, certain items of income or loss are excluded from net earnings from self-employment of an S corporation shareholder under the provision, such as certain rental income, dividends and interest, and certain capital gains and losses.

Any wages of the shareholder from the disqualified S corporation are subject to FICA tax as under present law, and FICA withholding requirements apply as under present law.

A disqualified S corporation means (1) an S corporation that is a partner in a partnership that is engaged in a professional service business if substantially all of the S corporation's activities are performed in connection with the partnership, and (2) any other S corporation that is engaged in a professional service business if the principal asset of the business is the reputation and skill of three or fewer employees. It is intended that an employee include an individual who is considered an employee for Federal tax purposes.

For example, assume that an S corporation's stock is owned by a group of architects. The S corporation becomes a partner in a partnership that is formed to enter a competition to design a particular building. The other partners are architects that are not owners of the S corporation. The partnership wins the competition and the partners, including shareholders of the S corporation, perform architectural services for 18 months in connection with the construction of the building that was the subject of the competition. At the same time, the S corporation provides architectural services with respect to the design and construction of several other buildings. At the end of the 18 months, the partnership is terminated. The S corporation is not a disqualified S corporation because substantially all its activities are not performed in connection with the partnership.

As another example, assume that two lawyers, Smith and Jones, form a law firm that specializes in criminal defense work. After several years of practice, Smith and Jones have each successfully defended a number of cases and the firm has hired associate lawyers and support staff to handle the cases brought to the firm based on Smith's and Jones' reputation and skill. In this situation, the principal asset of the business is the reputation and skill of Smith and Jones.

Under the provision, for SECA tax purposes, a shareholder's pro rata share of S corporation income or loss described in section 1366 that is attributable to the professional service business includes the pro rata share of each member of that shareholder's family of such items of income or loss of the S corporation. This rule applies if the family member does not provide substantial services with respect to the professional service business. For this purpose, family members are an individual's spouse, parents, children and grandchildren.<sup>702</sup>

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<sup>702</sup> A family member for this purpose is determined under the rules of section 318(a)(1), which identifies the individual's (1) spouse (other than a spouse who is legally separated from the individual under a decree of

Thus, for example, assume an individual owns 4 percent of the stock of an S corporation, and provides substantial services with respect to a medical professional service business engaged in by a partnership in which the S corporation is a partner. The individual's spouse, who provides no services with respect to the business, owns the other 96 percent of the stock of the S corporation. Under the provision, the service-providing shareholder includes in net earnings from self-employment his own pro rata share, and also the spouse's pro rata share of items of income or loss described in section 1366 that are attributable to the professional service business.

It is intended that a partnership or S corporation be considered as engaged in a professional service business if it, or a lower-tier entity, is engaged in the business. Thus, in the foregoing example, if the medical professional service business is conducted in a lower-tier partnership in which the S corporation has an interest through tiers of partnerships, the result is the same under the provision. It is intended that, under regulatory authority set forth in the provision, the Treasury provide prompt guidance to this effect. However, in the absence of guidance, it is intended that the provision be applied and interpreted in this manner.

A professional service business for this purpose means a trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

### **Treatment of partners**

Under the provision, the exclusion from SECA for a limited partner's distributive share of partnership income or loss does not apply to any partner who provides substantial services with respect to a professional service business in which the partnership is engaged. The present-law rule for general partners applies to such a partner for determining net earnings from self-employment. The partner takes into account for SECA tax purposes his or her distributive share (whether or not distributed) of partnership income or loss (including separately stated items). As under present law, specified types of income or loss are excluded from net earnings from self-employment of a partner, such as certain rental income, dividends and interest, certain gains, and other items.

A professional service business for this purpose means a trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

### **Regulatory authority**

Treasury regulatory authority is provided to carry out the purposes of the provision, including by prescribing guidance to prevent the avoidance of the purposes of the provision through tiered entities or otherwise. It is intended that guidance be provided promptly to

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divorce or separate maintenance), and (2) his or her children, grandchildren and parents. For this purpose, a legally adopted child is treated as a child by blood.

determine how taxpayers include amounts in net earnings from self-employment in situations in which multiple family members provide substantial services and multiple family members who do not provide substantial services are entitled to a pro rata share of items of income or loss of a S corporation.

**Effective Date**

The provision is effective for taxable years beginning after December 31, 2010.

## C. Corporate Provisions

### 1. Treatment of securities of a controlled corporation exchanged for assets in certain reorganizations (sec. 421 of the bill and sec. 361 of the Code)

#### Present Law

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 if the transfer is made by one corporation (“distributing”) of a part of its assets consisting of an active trade or business meeting certain requirements to a controlled subsidiary corporation (“controlled”), 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 (“divisive D reorganization”).<sup>703</sup>

No gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.<sup>704</sup> If property other than stock or securities is received (“other property”), gain is recognized to the extent the other property is not distributed.<sup>705</sup>

In addition, in the case of a transfer of money or other property received in the exchange to the corporation’s creditors in connection with the reorganization, gain is recognized to the extent the sum of the money and the fair market value of the other property exceeds the adjusted bases of the assets transferred (net of liabilities).<sup>706</sup> Such a transfer to creditors is aggregated with other assumptions of the transferor corporation’s liabilities by the transferee, which generally cause gain recognition if they exceed the adjusted basis of assets transferred.<sup>707</sup>

For example, if in a divisive D reorganization the controlled corporation either (1) directly assumes the debt of the distributing corporation, or (2) borrows and distributes cash to the distributing corporation to pay the distributing corporation’s creditors, such debt assumption or cash distribution is treated as money received by the distributing corporation, and is taxable to the extent it exceeds the distributing corporation’s basis in the assets transferred to the controlled corporation. By contrast, if the controlled corporation leverages itself by issuing its debt securities to the distributing corporation, the controlled corporation’s debt securities are not

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<sup>703</sup> Secs. 355 and 368(a)(1)(D). Section 355 imposes other requirements to avoid gain recognition at the corporate level with respect to the spin-off, split-up, or split-off, e.g., secs. 355(d) and (e).

<sup>704</sup> Sec. 361(a).

<sup>705</sup> Sec. 361(b).

<sup>706</sup> The last sentence of sec. 361(b)(3).

<sup>707</sup> Sec. 357(c).

treated as money received by the distributing corporation. Thus, the distributing corporation could use the controlled corporation's securities to retire the distributing corporation's own debt, recognize no gain, and be in the same economic position as if its debt had been directly assumed by the controlled corporation or as if it had retired its debt with cash received from the controlled corporation.

### **Explanation of Provision**

Under the provision, in the case of a divisive D reorganization, no gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock other than nonqualified preferred stock (as defined in section 351(g)(2)).<sup>708</sup> Thus, under the provision, securities and nonqualified preferred stock of the controlled corporation are treated as "other property."

Under the provision, the transferor corporation's gain on the exchange is recognized to the extent of the sum of money and the value of other property, including securities and nonqualified preferred stock, not distributed in pursuance of the plan of reorganization. Also, gain on the exchange is recognized to the extent that the sum of money and the value of all property other than stock that is not nonqualified preferred stock which is transferred to creditors exceeds the adjusted bases of the assets transferred (net of liabilities).

For example, under the provision, in a divisive D reorganization, the exchange of the controlled corporation's securities for the distributing corporation's securities would be treated in the same manner to the distributing corporation as (1) the assumption of the distributing corporation's debt by the controlled corporation or (2) the use of a cash distribution from the controlled corporation to retire debt of the distributing corporation.

### **Effective Date**

The provision applies to exchanges occurring after the date of enactment.

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<sup>708</sup> Section 351(g)(2) defines nonqualified preferred stock as preferred stock if (i) the holder has a right to require the issuer or a related person to redeem or purchase the stock, which right may be exercised within the 20 year period beginning on the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of redemption or purchase; (ii) the issuer or a related person is required to redeem or purchase the stock (within such 20 year period and not subject to such a contingency); (iii) the issuer or a related person has the right to redeem or purchase the stock (which right is exercisable within such 20 year period and not subject to such a contingency) and as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. There are exceptions for certain rights that are exercisable only on the death, disability or mental incompetency of the holder, or only upon the separation from service of a service provider who received the right as reasonable compensation for services, and for certain situations involving publicly traded stock.

Nonqualified preferred stock is treated in the same manner as securities under section 351 and thus is not qualified consideration that may be received tax free by a contributing shareholder. Sections 354(a)(2)(C) and 356(e) treat nonqualified preferred stock as taxable consideration if received in exchange for stock by shareholders of a corporation that itself is a party to a reorganization (except to the extent received in exchange for other nonqualified preferred stock); and section 355 contains a similar rule (sec. 355(a)(3)(D)).

However, the provision does not apply to any exchange in connection with a transaction which is (i) made pursuant to a written agreement which was binding on March 15, 2010, and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before such date,<sup>709</sup> or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

## **2. Taxation of boot received in reorganizations (sec. 422 of the bill and secs. 356 and 312 of the Code)**

### **Present Law**

#### **Distributions and stock redemptions in general**

If a corporation distributes cash (or other property not permitted to be received without tax)<sup>710</sup> 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.<sup>711</sup> Amounts in excess of such earnings and profits are treated 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.<sup>712</sup> 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.

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<sup>709</sup> It is intended that the only transaction for which transition relief is available under the language of (ii) is the specific transaction for which the ruling was requested.

<sup>710</sup> Certain distributions of stock are permitted to be received tax free (sec. 305) as are certain distribution 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.

<sup>711</sup> Sec. 301.

<sup>712</sup> Sec. 302.

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<sup>713</sup> (or would eliminate the dividend if it is filing a consolidated return with the payor).<sup>714</sup> If the recipient is a foreign person and the payor is a U.S. 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 profits is limited to the ratable share of the earnings and profits attributable to the redeemed stock.<sup>715</sup>

### **Section 304**

Under section 304, if one corporation purchases stock of a related corporation (the "target corporation") in exchange for property, the transaction generally is recharacterized as a redemption. The tests described above with respect to redemptions determine whether or not the transfer is treated as an exchange or as a distribution of property. To the extent a section 304(a)(1) transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred 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.<sup>716</sup> In the case of a section 304 transaction, both the dividend amount and the source of such dividend are determined as if the property transferred to the transferor were distributed by the acquiring

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<sup>713</sup> Sec. 243.

<sup>714</sup> Treas. Reg. sec. 1.1502-13(f).

<sup>715</sup> Sec. 312(n)(7).

<sup>716</sup> Sec. 304(a)(1).



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.<sup>717</sup>

Special rules apply if the acquiring corporation in a section 304 transaction is a foreign corporation.<sup>718</sup> The foreign acquiring corporation's earnings and profits that is taken into account is limited to the portion of such earnings and profits that (1) is 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) was 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"). Except as otherwise provided by the Secretary, provisions relating to certain exclusions from earnings and profits<sup>719</sup> apply for purposes of this rule.

### **Boot in reorganizations and certain 355 distributions**

In general, gain or loss is not recognized with respect to exchanges of stock and securities in corporate reorganizations (or section 355 divisive stock distributions). If such exchanges also involve the receipt of nonqualifying consideration ("boot"), then gain is recognized up to the amount of the boot. No loss is allowed.<sup>720</sup> 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 shareholder's dividend recognized is limited by the amount of gain the shareholder would have realized if the stock had been treated as sold in a taxable transaction. 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."<sup>721</sup> If the amount of the distribution that is within the gain limitation exceeds the allocable portion of accumulated earnings and profits, the excess is treated as gain first, within the amount of realized gain (rather than as recovery of basis).<sup>722</sup>

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<sup>717</sup> Sec. 304(b)(2).

<sup>718</sup> Sec. 304(b)(5).

<sup>719</sup> Sec. 1248(d).

<sup>720</sup> Sec. 356(c).

<sup>721</sup> 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.

<sup>722</sup> In certain circumstances a distribution may be treated as a dividend separate from the reorganization, and hence not subject to the special rules of section 356. See *Bazley v. Commissioner*, 331 U.S. 737 (1947); Treas. Reg. sec. 1.301-1(l); Proposed Treas. Reg. Sec. 1.368-2(m)(4).

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*,<sup>723</sup> 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 section 355 exchange.

As discussed above, under section 356 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. It is the position of the IRS and at least one circuit court under present law that, for purposes of determining the deemed dividend under section 356(a)(2), the earnings and profits of the transferor and transferee corporation should both be taken into account when the corporations are commonly owned.<sup>724</sup> Other courts, however, have taken the position that the earnings and profits should be limited to that of the target transferor corporation, even in the case of common ownership.<sup>725</sup>

If a reorganization distribution 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, earnings 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.<sup>726</sup> There is a lack of clarity under present law whether a limitation on 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.

Some reorganizations (under sections 368(a)(1)(D)<sup>727</sup>, (E)<sup>728</sup>, and (F)<sup>729</sup>) necessarily involve corporations under common control, or restructurings of a single corporation. Other

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<sup>723</sup> 489 U.S. 726 (1989).

<sup>724</sup> 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).

<sup>725</sup> *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).

<sup>726</sup> Rev. Rul. 72-327, 1972-2 C. B. 197.

<sup>727</sup> 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

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 apply for the dual purposes of (i) preserving the U.S. ability to tax gains attributable to the accrued appreciation in assets that leave the U.S. tax system and (ii) requiring the inclusion of previously untaxed foreign earnings of certain foreign subsidiaries (hereinafter the “earnings repatriation purpose”).<sup>730</sup> 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 gain shall be recognized on such transfer, be considered a corporation.<sup>731</sup> 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).<sup>732</sup> Section 367(b)(1) provides that a foreign corporation shall be

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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).

<sup>728</sup> Section 368(a)(1)(E) refers to a recapitalization.

<sup>729</sup> Section 368(a)(1)(F) refers to a mere change in identity, form, or place of organization of one corporation, however effected.

<sup>730</sup> H.R. Rep. No. 94-658 (1975).

<sup>731</sup> 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.

<sup>732</sup> Sec. 367(b)(1). Specifically, section 367(b) applies to an exchange described in section 332, 351, 354, 355, 356 or 361 in connection with which there is no transfer of property described in section 367(a)(1).

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.

The Treasury Department has recently exercised its authority under section 367(b) to address transactions that may result in the repatriation of earnings without the recognition of income or dividends.<sup>733</sup>

### **Explanation of Provision**

The provision 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 (determined with the application of section 318(a)).<sup>734</sup> In such a case, except as otherwise provided in regulations, the amount of other property or money shall be treated as a dividend to the extent of the earnings and profits of the corporation. Also, (except as otherwise provided under the foregoing regulatory authority), in the case of an acquisitive reorganization under section 368(a)(1)(D) (and in the case of any other reorganization specified by the Secretary), the provision requires that the amount treated as a dividend include the earnings and profits of each corporation which is a party to such reorganization, and that the amount of the dividend (and the source thereof) shall be determined under rules similar to section 304(b)(2) and section 304(b)(5).<sup>735</sup>

The remainder (if any) of the gain under section 356(a)(1) shall be treated as gain from the exchange of property.

The longstanding treatment of boot as gain first (rather than basis recovery) where boot would have the effect of the distribution of a dividend but is not treated as a dividend for lack of

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<sup>733</sup> Notice 2006-85, 2006-2 C.B. 677; Notice 2007-48, 2007-1 C.B. 1428; Treas. Reg. sec. 1.367(b)-14T.

<sup>734</sup> The provision does not change the holding of *Clark v. Commissioner*, 489 U.S. 726 (1989) regarding whether an exchange has the effect of the distribution of a dividend.

<sup>735</sup> For this purpose, it is expected that the references in section 304(b)(2) to the “issuing” and the “acquiring” corporation will be modified as appropriate. For example, it is expected that except as otherwise specified by the Secretary, the concept of the “acquiring corporation” would retain the same meaning as in section 304, but the corporation whose assets (or stock) is acquired would be substituted for the “issuing” corporation.

It is intended that the reference in this provision to section 304(b) reflect the provisions of that section as in effect at any given time. For example, section 405 of the current bill would modify section 304(b)(5) in certain cases. If that modification would be applicable when enacted, then similar rules would apply under this provision. The intent is to conform the treatment of an acquisitive reorganization under section 368(a)(1)(D) to the treatment under section 304(b) (unless the Secretary provides otherwise in guidance).

earnings and profits, has not been altered, other than to specify (or allow regulations to specify) the earnings and profits that are taken into account.

References to “ratable share” and “undistributed earnings and profits accumulated” have been eliminated. Thus, it is intended that earnings and profits references in section 356(a)(2) not be interpreted to exclude current year earnings and profits.

One example of a type of transaction to which the Secretary may wish to extend the application of the new rules looking to the earnings and profits of more than one corporation is the case of a triangular reorganization under section 368(a)(2)(D) or 368(a)(2)(E) that involves common control that is similar to that of either an acquisitive transaction under section 368(a)(1)(D) or a transaction under section 304. However, the authority of the Secretary to apply similar rules to other situations is not intended to be limited to such triangular reorganizations.

In addition, the provision imposes a rule similar to the rule of section 312(n)(7) to the extent a distribution is treated as an exchange to which section 356(a)(1) applies.

### **Effective Date**

The provision is effective for exchanges after the date of enactment.

However, the provision does not apply to any exchange between persons that are not related within the meaning of section 267 or 707(b), which is (i) made pursuant to a written agreement which was binding on May 20, 2010 and at all times thereafter, (ii) described in a ruling request<sup>736</sup> submitted to the IRS on or before such date, or (iii) described in a public announcement or filing with the SEC on or before such date.

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<sup>736</sup> It is intended that the only transaction for which transition relief is available under the language of (ii) is the specific transaction for which the ruling was requested.

## **D. Other Provisions**

### **1. Modifications with respect to Oil Spill Liability Trust Fund (sec. 431 of the bill and secs. 4611 and 9509 of the Code)**

#### **Present Law**

The Oil Spill Liability Trust Fund financing rate was reinstated effective April 1, 2006.<sup>737</sup> The tax is currently eight cents per barrel through December 31, 2016, and then increases to nine cents per barrel for calendar year 2017. The tax does not apply after December 31, 2017.

The tax generally applies to crude oil received at a U.S. refinery and to petroleum products entered into the United States for consumption, use, or warehousing.<sup>738</sup>

For crude oil received at a refinery, the operator of the U.S. refinery is liable for the tax. For imported petroleum products, the person entering the product for consumption, use, or warehousing is liable for the tax. For certain uses and exports, the person using or exporting the crude oil is liable for the tax. No tax is imposed with respect to any petroleum product if the person who would be liable for such tax establishes that a prior oil spill tax has been imposed with respect to such product.

The Oil Spill Liability Trust Fund is a funding source to pay removal costs and damages resulting from oil spills. The fund is used for costs not directly paid by the responsible party. The Code places limitations on expenditures from the Oil Spill Liability Trust Fund. The maximum amount that may be paid from the Oil Spill Liability Trust Fund with respect to any single incident cannot exceed \$1 billion, and natural resource damage assessments and claims in connection with any single incident cannot exceed \$500 million. Except in the case of payments of removal costs, a payment may be made from the trust fund only if the amount in the trust fund after such payment will not be less than \$30 million.

#### **Explanation of Provision**

The provision increases and extends the oil spill tax from eight cents per barrel to 34 cents per barrel through December 31, 2020. The provision also increases the maximum amount that may be paid from the Oil Spill Liability Trust Fund with respect to any single incident from \$1 billion to \$5 billion. The limitation on natural resource damage assessments and claims in connection with any single incident is increased from \$500 million to \$2.5 billion. The rule requiring a \$30 million minimum balance in the trust fund is unchanged by the provision.

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<sup>737</sup> Sec. 4611(f).

<sup>738</sup> The term “crude oil” includes crude oil condensates and natural gasoline. The term “petroleum product” includes crude oil. The tax also applies to certain uses and the exportation of domestic crude oil. If any domestic crude oil is used in or exported from the United States, and before such use or exportation no oil spill tax was imposed on such crude oil, then the oil spill tax is imposed on such crude oil. The tax does not apply to any use of crude oil for extracting oil or natural gas on the premises where such crude oil was produced.

### **Effective Date**

The increase in financing rate is effective beginning the first quarter that is more than 60 days after the date of enactment. The increase in the limitations on expenditures related to a single incident is effective for expenditures made after the date of enactment. The extension of the tax from December 31, 2017 to December 31, 2020 is effective on the date of enactment.

## **2. Time for payment of corporate estimated taxes (sec. 432 of the bill and sec. 6655 of the Code)**

### **Present Law**

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.<sup>739</sup> 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. In the case of a corporation with assets of at least \$1 billion (determined as of the end of the preceding taxable year):

- (i) payments due in July, August, or September, 2014, are increased to 173.5 percent of the payment otherwise due;<sup>740</sup>
- (ii) payments due in July, August or September, 2015, are increased to 121.5 percent of the payment otherwise due;<sup>741</sup> and
- (iii) payments due in July, August or September, 2019, are increased to 106.5 percent of the payment otherwise due.<sup>742</sup>

For each of the periods impacted, the next required payment is reduced accordingly.

### **Explanation of Provision**

The provision increases the required payment of estimated tax otherwise due in July, August, or September, 2015, by 36.0 percentage points.

### **Effective Date**

The provision is effective on the date of enactment of the bill.

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<sup>739</sup> Sec. 6655.

<sup>740</sup> Pub L. No. 111-152; Pub. L. No. 111-147, Sec. 561, par. (1); Pub. L. No. 111-124, Sec. 4; Pub. L. No. 111-92, Sec. 18; Pub. L. No. 111-42, Sec. 202(b)(1).

<sup>741</sup> Pub. L. No. 111-147, Sec. 561, par. (2).

<sup>742</sup> Pub. L. No. 111-147, Sec. 561, par. (3).

## **TITLE V – HEALTH PROVISIONS**

### **A. Establish CMS-IRS data match to identify tax-delinquent providers (sec. 521 of the bill and sec. 6103 of the Code)**

#### **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 in the Internal Revenue Code. Section 6103 contains a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances. For example, section 6103 provides for the disclosure of certain return information for purposes of establishing the appropriate amount of any Medicare Part B premium subsidy adjustment.

Section 6103(p)(4) requires, as a condition of receiving returns and return information, that Federal and State agencies (and certain other recipients) provide safeguards as prescribed by the Secretary of the Treasury by regulation to be necessary or appropriate to protect the confidentiality of returns or return information. Unauthorized disclosure of a return or return information is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both, together with the costs of prosecution.<sup>743</sup> The unauthorized inspection of a return or return information is punishable by a fine not exceeding \$1,000 or imprisonment of not more than one year, or both, together with the costs of prosecution.<sup>744</sup> An action for civil damages also may be brought for unauthorized disclosure or inspection.<sup>745</sup>

#### **Explanation of Provision**

Upon written request from the Secretary of Health and Human Services, the IRS is permitted to disclose to officers and employees of the Department of Health and Human Services the following information with respect to a taxpayer who has applied to enroll, or reenroll, as a provider of services or supplier under the Medicare program under title XVIII of the Social Security Act:

- Taxpayer identity information with respect to such person (i.e. the name of the person with respect to whom a return is filed, that person's mailing address, and taxpayer identifying number),
- The amount of the delinquent tax debt owed by that taxpayer, and
- The taxable year to which the delinquent tax debt relates.

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<sup>743</sup> Sec. 7213.

<sup>744</sup> Sec. 7213A.

<sup>745</sup> Sec. 7431.



For purposes of the provision, the term “delinquent tax debt” means an outstanding debt under Title 26 for which a notice of lien has been filed. Such term does not include a debt that is being paid in a timely manner pursuant to an installment agreement (under section 6159) or offer in compromise (under section 7122). Nor does it include a debt for which a collection due process hearing (under section 6330) is requested, pending, or completed and no payment is required.

The information disclosed under the provision may be used by officers and employees of the Department of Health and Human Services only for the purposes of, and to the extent necessary in, establishing the taxpayer’s eligibility for enrollment or reenrollment in the Medicare program, or in any administrative or judicial proceeding relating to, or arising from, a denial of such reenrollment, or in determining the level of enhanced oversight to be applied with respect to such taxpayer pursuant to section 1866(j)(3) of the Social Security Act.

The provision makes a corresponding amendment to the Social Security Act to provide that in reviewing the application of a provider of services or supplier to enroll or reenroll in the Medicare program, the Secretary of Health and Human Services shall take into account the disclosed information supplied by the Secretary of the Treasury (IRS) in determining whether to deny such application or to apply enhanced oversight to such provider of services or supplier if it is determined that such provider of services or supplier owes a delinquent tax debt. The provision also makes technical and conforming changes to clarify the Secretary of Health and Human Services’ ability to recover Medicare obligations from providers and suppliers that share the same tax identification number.

#### **Effective Date**

The provision is effective on the date of enactment.

## TITLE VI – OTHER PROVISIONS

### A. The Individual Indian Money Account Litigation (sec. 607 of the bill)

#### Present Law

Under section 61 of the Code, gross income includes all income from whatever source derived. The Code includes a number of exceptions from this rule, including exceptions for amounts of any damages received on account of personal physical injuries under section 104(a)(2). There is no specific exclusion from gross income for amounts received by individual Indians pursuant to the proposed settlement reached on December 7, 2009 between Elouise Cobell, et al. and the Secretary of Interior, et al. (the “Settlement”).

In general, individual Indians, regardless of tribal affiliation, are subject to Federal income taxes and section 61 of the Code, even if the income is distributed to individual Indians out of income otherwise immune from taxation when first received by the tribe.<sup>746</sup> However, certain types of income earned by individual Indians are not subject to Federal tax such as income derived from certain fishing activities.<sup>747</sup> As another example, income derived directly from individually allotted land held in trust by the Federal government for the benefit of an individual Indian is excluded.<sup>748</sup> Income is derived directly from trust land if it is generated principally from the use of allotted land and resources rather than from capital improvements upon the land, and includes income from logging, mining, farming, or ranching activities.<sup>749</sup>

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<sup>746</sup> *Squire v. Capoeman*, 351 U.S. 1, 6 (1956). Per capita payments of net revenues from gaming activities conducted or licensed by any Indian tribe are specifically made subject to Federal taxes by the Indian Gaming Regulatory Act, 25 U.S.C. sec. 2710(b)(3)(D), Pub. L. No. 100-497 (Oct. 17, 1988).

<sup>747</sup> Sec. 7873 (exemption of income from treaty fishing rights).

<sup>748</sup> Section 5 of the General Allotment Act of 1887, as amended, provided for tribal lands to be allotted to individual Indians in trust for a period of years, after which the lands were to be conveyed to the allottees in fee “free of all charge or incumbrance whatsoever.” 25 U.S.C. sec. 348. This provision has been interpreted to prevent taxation of income or capital gains “derived directly” from allotted land while it remains in trust. *Squire v. Capoeman*, 351 U.S. 1 (1956); Rev. Rul. 57-407, 1957-2 C.B. 45 (any gain from the sale or exchange of the land while it is still held in trust is not subject to tax); Rev. Rul. 67-284, 1967-2 C.B. 55 (lists several types of income that will be treated as “derived directly” from allotted land including, rentals (including crop rentals), royalties, and proceeds from the sale of natural resources from the land. A number of courts have held that the exclusion is only available for income derived from land allotted to the individual earning the income and is not available for income derived from land leased from the tribe or another individual to whom the land is allotted. See *Kieffer v. Comm’r*, T.C. 1998-202; *Anderson v. United States*, 845 F.2d 206 (9th Cir. 1988); *Holt v. Comm’r*, 364 F.2d 38 (8th Cir. 1966); but see *Campbell v. Comm’r*, T.C. Memo 1997-502 at 19. The exclusion does not extend to income derived from the reinvestment of income derived from allotted land. *Capoeman*, 351 U.S. at 9.

<sup>749</sup> *Capoeman* applies to allotments issued pursuant to tribe-specific allotment statutes, regardless of whether the General Allotment Act applies to those allotments. See *United States v. Hallam*, 304 F.2d 629 (10th Cir. 1962) (income from Quapaw allotments in form of rents, royalties, and proceeds from restricted allotted lands exempt); *Stevens v. Commissioner*, 452 F.2d 741 (9th Cir. 1971) (construing Ft. Belknap Allotment Act to find farming and ranching income exempt); *Big Eagle v. United States*, 300 F.2d 765 (Ct. Cl. 1962) (receiving royalties from tribal mineral deposits exempt by virtue of Osage Allotment Act); Rev. Rul. 74-13, 1974-1 C.B. 14 (exemption described as applying to restricted lands generally rather than specifically to General Allotment Act lands).

### **Explanation of Provision**

A proposed Settlement has been reached in a class action lawsuit filed in 1996 against the Federal government for mismanagement of individual Indian trust accounts and trust assets. The lawsuit seeks a complete historical accounting as well as the correction of all individual Indian trust account balances due to this mismanagement. The Settlement is with the Secretary of the Interior, the Assistant Secretary of the Interior-Indian Affairs, and the Secretary of the Treasury. The individual Indian trust accounts relate to land, oil, natural gas, mineral, timber, grazing, water and other resources and rights on or under individual Indian lands.

Under the terms of the Settlement, the government will create a \$1.412 billion Accounting/Trust Administration Fund and a \$2 billion Trust Land Consolidation Fund. The Settlement also creates a federal Indian Education Scholarship Fund of up to \$60 million to improve access to higher education for Indian youth.

The provision approves the Settlement, including the appropriation and payment of Federal funds. As required under the Settlement, the provision confirms that the amounts received by an individual Indian as a lump sum or a periodic payment pursuant to the Settlement will not be included in gross income and will not be taken into consideration for purposes of applying any provision of the Code that takes into account excludible income in computing adjusted gross income or modified adjusted gross income. The provision also provides that for purposes of determining eligibility under any Federal assisted program, the amounts received will not be treated as income for the month during which the amounts were received or as a resource during the 1-year period beginning on the date of receipt.

### **Effective Date**

The provision is effective upon date of enactment.

**B. Refunds Disregarded in the Administration of Federal  
Programs and Federally Assisted  
(sec. 611 of the bill and sec. 6409 of the Code)**

**Present Law**

The Secretary is authorized to refund or credit overpayments of taxes.<sup>750</sup> Refunds and credits issued under this authority are not gain to the taxpayer and are not includible in income. In addition to such refunds, qualifying individuals may receive refundable credits under various provisions in the Code. Some of these credits are not taken into account for purposes of determining eligibility for benefits or assistance under Federal programs, but the treatment of such credits is not uniform. For example, for purposes of determining an individual's eligibility under any Federal program or federally funded State or local program, the child tax credit<sup>751</sup> is not considered a resource for the month of receipt and the following month,<sup>752</sup> but the making work pay credit<sup>753</sup> is not so considered for the month of receipt and the following two months.<sup>754</sup> The earned income credit has a similar rule to the child tax credit but only with respect to certain specifically listed benefit programs.<sup>755</sup>

**Explanation of Provision**

The provision provides that any tax refund (or advance payment with respect to a refundable credit) made to any individual in calendar year 2010 is not taken into account as income or as a resource for a period of 12 months from receipt 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. Nothing in this provision affects the treatment of the refund for purposes of determining the individual's tax liability under the Code.

**Effective Date**

The provision is effective for amounts received after December 31, 2009.

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<sup>750</sup> Sec. 6402.

<sup>751</sup> Sec. 24.

<sup>752</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, sec. 203.

<sup>753</sup> Sec. 36A.

<sup>754</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 1001(c).

<sup>755</sup> Sec. 32(l).

**C. Extension of Duty Suspensions on Cotton Shirting  
Fabrics and Related Provisions<sup>756</sup>  
(sec. 616 of the bill)**

**Present Law**

In 2006, as part of the last miscellaneous tariff bill, Congress enacted a program for U.S. cotton shirt manufacturers to respond to a commercial disadvantage caused by an inverted tariff. The legislation created a “cotton trust fund,” which provides payments to U.S. shirt makers and U.S. cotton fabric and yarn producers, and created a pima cotton promotion program. The trust fund is funded through the revenue collected from tariffs on cotton textiles imports (primarily yarns and fabrics). The legislation also includes duty suspensions and reductions on high-end cotton fabrics and yarns, subject to quantitative limitations. The authority to transfer tariff revenue to the trust fund expired on October 1, 2008, and the duty suspensions expired on December 31, 2009.

**Explanation of Provision**

The provision included in the bill would reauthorize the program until December 31, 2013.

**Effective Date**

The provision is effective on the date of enactment.

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<sup>756</sup> This item was prepared by the majority staff of the House Ways and Means Committee.