TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN H.R. 5486, THE "SMALL BUSINESS JOBS TAX RELIEF ACT OF 2010," FOR CONSIDERATION ON THE FLOOR OF THE HOUSE OF REPRESENTATIVES

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CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions contained in H.R. 5486, the "Small Business Jobs Tax Relief 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").

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in H.R. 5486, the "Small Business Jobs Tax Relief Act of 2010," for Consideration on the Floor of the House of Representatives,* (JCX-31-10), June 15, 2010. This document can also be found on our website at www.jct.gov.

I. SMALL BUSINESS TAX INCENTIVES

A. Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock (sec. 501 of the bill and sec. 1202 of the Code)

Present Law

In general

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

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[3] A percentage of the excluded gain is an alternative minimum tax preference;[4] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Thus, under present law, gain from the sale of qualified small business stock is taxed at effective rates of 14 percent under the regular tax[5] and (i) 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (ii) 19.98 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.[6]

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[2] Sec. 1202.

[3] Sec. 1(h).

[4] 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.

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

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

Temporary increase in exclusion

Under present law, the percentage exclusion for qualified small business stock acquired after February 17, 2009, and before January 1, 2011, is increased to 75 percent. As a result of the increased exclusion, gain from the sale of this qualified small business stock held at least five years is taxed at effective rates of seven percent under the regular tax[7] and 12.88 percent under the alternative minimum tax.[8]

Explanation of Provision

Under the provision, the percentage exclusion for qualified small business stock is increased to 100 percent and the minimum tax preference does not apply. Thus, no regular tax or alternative minimum tax is imposed on the sale of this stock held at least five years.

Effective Date

The provision is effective for stock issued after March 15, 2010, and before January 1, 2012.

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

[8] The 46 percent of gain included in alternative minimum tax 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).

B. Limitations and Reporting on Certain Penalties

1. Limitation on penalty for failure to disclose certain information (sec. 511 of the bill and sec. 6707A of the Code)

Present Law

The reporting requirements of sections 6011 through 6112 create interlocking disclosure obligations for both taxpayers and advisors. Each of these disclosure statutes has a parallel penalty provision that enforces it. Prior to enactment of the American Jobs Creation Act of 2004[9], no penalty was imposed on taxpayers who failed to disclose participation in transactions subject to section 6011. For disclosures that were due after enactment of that legislation, a strict liability penalty under section 6707A applies to any failure to disclose a reportable transaction.

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[10] A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[11] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[12]

Transactions falling under the first and last categories of reportable transactions are transactions that are described in publications issued by the Treasury Department and identified as one of these types of transaction. A listed transaction is defined as a reportable transaction which is the same as, or substantially similar[13] to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[14] A transaction of interest is one that is the same or substantially similar to a transaction identified by the Secretary as one about which the Secretary is concerned but does not yet have sufficient knowledge to determine that the transaction is abusive.[15]

The other categories of reportable transactions are not specifically identified in published guidance, but are defined as classes of transactions sharing certain characteristics. In general, a

[9] Pub. L. No. 108-357.

[10] Treas. Reg. sec. 1.6011-4.

[11] Sec. 6707A(c)(1).

[12] Treas. Reg. sec. 1.6011-4(b)(2)-(6).

[13] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011-4(c)(4).

[14] Sec. 6707A(c)(2).

[15] Treas. Reg.sec. 1.6011-4(b)(6).

transaction is considered to be offered to a taxpayer under conditions of confidentiality if an advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).[16] A transaction involves contractual protection if (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[17] A reportable loss transaction generally includes any transaction that results in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[18] Treasury has announced its intention to add a sixth category of reportable transactions, patented transactions, but has not yet done so.[19]

Section 6707A imposes a penalty for failure to comply with the reporting requirements of 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under section 6011 by both the partnership and its partners.[20] The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is $100,000 for natural persons and $200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is $10,000 for natural persons and $50,000 for all other persons.

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods specified by the Secretary. Disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[21] However, the taxpayer is only required to report the penalty one time. A public entity that is subject to a gross valuation misstatement penalty under section 6662(h) attributable

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[16] Treas. Reg. sec. 1.6011-4(b)(3).

[17] Treas. Reg. sec. 1.6011-4(b)(4).

[18] Treas. Reg. sec. 1.6011-4(b)(5).

[19] Proposed Treas. Reg. sec. 1.6011-4(b)(7), published September 26, 2007 (REG-129916-07).

[20] See, e.g., Treas. Reg. sec. 1.6011-4(c)(3)(ii), Example 2.

[21] Sec. 6707A(e).

to a non-disclosed listed transaction or non-disclosed reportable avoidance transaction may also be required to make disclosures in its SEC filings.[22]

For reportable transactions other than listed transactions, the Commissioner of the Internal Revenue Service ("IRS") or his delegate can rescind (or abate) the penalty only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.[23] The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. Determinations by the Commissioner regarding rescission are not subject to judicial review.[24] The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission. The section 6707A penalty cannot be waived with respect to a listed transaction.

The section 6707A penalty is assessed in addition to any accuracy-related penalties. If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable cause exception to the accuracy-related penalty is not available, and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[25] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[26] The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[27]

Explanation of Provision

The provision changes the general rule for determining the amount of the applicable penalty to achieve proportionality between the penalty and the tax savings that were the object of the transaction, retains the current penalty amounts as the maximum penalty that may be imposed, and establishes a minimum penalty.

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[22] Sec. 6707A(e)(2)(C); Rev. Proc. 2005-51, 2005-2 CB 296.

[23] In determining whether to rescind (or abate) the penalty for failing to disclose a reportable transaction on the grounds that doing so would promote compliance with the tax laws and effective tax administration, it is intended that the IRS Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

[24] This does not limit the ability of a taxpayer to challenge whether a penalty is appropriate (e.g., a taxpayer may litigate the issue of whether a transaction is a reportable transaction (and thus subject to the penalty if not disclosed) or not a reportable transaction (and thus not subject to the penalty)).

[25] Sec. 6662A(c).

[26] Sec. 6664(d).

[27] Sec. 6707A(d).

First, it provides a general rule that a participant in a reportable transaction who fails to disclose the reportable transaction as required under section 6011 is subject to a penalty equal to 75 percent of the reduction in tax reported on the participant's income tax return as a result of participation in the transaction, or that would result if the transaction were respected for Federal tax purposes. Regardless of the amount determined under the general rule, the penalty for each such failure may not exceed certain maximum amounts. The maximum annual penalty that a taxpayer may incur for failing to disclose a particular reportable transaction other than a listed transaction is $10,000 in the case of a natural person and $50,000 for all other persons. The maximum annual penalty that a taxpayer may incur for failing to disclose a listed transaction is $100,000 in the case of a natural person and $200,000, for all other persons.

The provision also establishes a minimum penalty with respect to failure to disclose a reportable or listed transaction. That minimum penalty is $5,000 for natural persons and $10,000 for all other persons.

The following examples illustrate the operation of the maximum and minimum penalties with respect to a partnership or a corporation. First, assume that two individuals participate in a listed transaction through a partnership formed for that purpose. Both partners, as well as the partnership, are required to disclose the transaction. All fail to do so. The failure by the partnership to disclose its participation in a listed or otherwise reportable transaction is subject to the minimum penalty of $10,000, because income tax liability is not incurred at the partnership level nor reported on a partnership return. The partners in such partnership who also failed to comply with the reporting requirements of section 6011 are each subject to a penalty based on the reduction in tax reported on their respective returns.

In the second example, assume that a corporation participates in a single listed transaction over the course of three taxable years. The decrease in tax shown on the corporate returns is $1 million in the first year, $100,000 in the second year, and $10,000 in the third year. If the corporation fails to disclose the listed transaction in all three years, the corporation is subject to three separate penalties: a penalty of $200,000 in the first year (as a result of the cap on penalties), a $75,000 penalty in the second year (computed under the general rule) and a $10,000 penalty in the third year (as a result of the minimum penalty) for total penalties of $285,000.

Effective Date

The provision applies to all penalties assessed under section 6707A after December 31, 2006.

2. Annual Reports on penalties and certain other enforcement actions (sec. 512 of the bill)

Present Law

Transactions that have the potential for tax avoidance are required to be disclosed by both the taxpayers who engage in the transaction and the various professionals who provide advice with respect to such transactions. Failure to comply with the reporting and disclosure requirements may result in assessment of penalties against both the taxpayer and material advisor and the use of special enforcement measures.

Reporting obligations

These disclosure requirements[28] create interlocking disclosure obligations for both taxpayers and advisors. A taxpayer is required to disclose with its tax return certain information with respect to each reportable transaction, as defined in regulations.[29] Each advisor who provides material advice with respect to any reportable transaction (including any listed transaction) is required to file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[30] Finally, the advisor is required to maintain a list of those persons he has advised with respect to a reportable transaction and to provide the list to the IRS upon request.[31]

A reportable transaction is defined as one that the Treasury Secretary requires to be disclosed based on its potential for tax avoidance or evasion.[32] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[33]

Penalties and other enforcement tools related to reportable transactions

Each of the disclosure statutes has a parallel penalty provision to aid enforcement. The taxpayer who participates in a reportable transaction and fails to disclose it is subject to a strict liability penalty.[34] The penalty is assessed in addition to any accuracy-related penalties. It may be rescinded with respect to reportable transactions other than listed transactions. Rescission is

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[28] Secs. 6011, 6111, and 6112.

[29] Treas. Reg. sec. 1.6011-4.

[30] Sec. 6111.

[31] Sec. 6112.

[32] Sec. 6707A(c)(1) states that the term means "any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." Sections 6111(b)(2) and 6112 both define "reportable transaction" by reference to the definition in section 6707A(c). The definition of "listed transaction" similarly depends upon identification of transactions by the Secretary as tax avoidance transactions for purposes of section 6011.

[33] Treas. Reg. sec. 1.6011-4(b)(2)-(6).

[34] Section 6707A imposes a penalty for failure to comply with the reporting requirements of 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under section 6011 by both the partnership and its partners.[34] The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is $100,000 for natural persons and $200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is $10,000 for natural persons and $50,000 for all other persons. A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods specified by the Secretary. Failure to comply with this reporting requirement may result in assessment of a second tier penalty.

discretionary and conditioned upon a determination by the Commissioner that rescinding the penalty would promote compliance and effective tax administration.[35] The Code also imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction). It may be rescinded, subject to limitations similar to those applicable to rescission of the penalty imposed on investors.[36] The IRS may also submit a written request that a material advisor make available the list required to be maintained under section 6612(a). A failure to make the list available upon written request is subject to a penalty of $10,000 per day for as long as the failure continues, unless the advisor can establish reasonable cause for the failure.[37]

In addition to the penalties that specifically address the failure to comply with the disclosure and reporting obligations, other special enforcement provisions are applicable to reportable transactions. An understatement arising from any listed transactions or from a reportable transaction for which a significant purpose is avoidance or evasion of Federal income tax will be subject to an accuracy-related penalty,[38] unless the taxpayer can establish that the failure was due to reasonable cause as determined under a standard that is more stringent than that applicable to other accuracy-related penalties.[39]

If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable cause exception is not available and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[40] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[41] Finally, a new exception to the statute of limitations provides that the period is suspended if a listed transaction is not properly disclosed.[42] If the transaction is disclosed either because the taxpayer files the proper disclosure form or a material advisor identifies the

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[35] Sec. 6707A(d). In determining whether to rescind (or abate) the penalty for failing to disclose a reportable transaction on the grounds that doing so would promote compliance with the tax laws and effective tax administration, it is intended that the IRS Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

[36] Section 6707 provides a penalty in the amount of $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

[37] Sec. 6708.

[38] Sec. 6662A.

[39] Sec. 6664(d).

[40] Sec. 6662A(c).

[41] Sec. 6664(d).

transaction to the IRS in a list maintained under section 6112, the period will remain open for at least one year from the earlier of date of the disclosure by the investor or the disclosure by the material advisor with respect to that transaction.

The Code authorizes civil actions to enjoin any person from specified conduct relating to tax shelters or reportable transactions.[43] The specified conduct includes failure to comply with respect to the requirements relating to the reporting of reportable transactions[44] and the keeping of lists of investors by material advisors.[45] Thus, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction. In addition, injunctions, monetary penalties and suspension or disbarment are authorized with respect to violations of any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

Reports to Congress by the Secretary

The Secretary is required to maintain records and report on the administration of the penalties for failure to disclose a reportable transaction in two ways. First, each decision to rescind a penalty imposed under section 6707 or section 6707A must be memorialized in a record maintained in the Officer of the Commissioner.[46] That record must include a description of the facts and circumstances of the violation, the reasons for the decision to rescind, and the amount rescinded. Second, the IRS is required to submit an annual report to Congress on the administration of the rescission authority under both sections 6707 and 6707A. The information with respect to the latter is to be in summary form, while the information on rescission of penalties imposed against material advisors is to be more detailed.[47] The report is not required to address administration of the other enforcement tools described above.

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[42] Sec. 6501(c)(10).

[43] Sec. 7408.

[44] Sec. 6707.

[45] Sec. 6708.

[46] Section 6707(c) incorporates by reference the provisions of section 6707A(d), which details the extent of the Commissioner's authority to rescind the penalty.

[47] AJCA provides, "The Commissioner of Internal Revenue shall annually report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate--

(1) a summary of the total number and aggregate amount of penalties imposed, and rescinded, under section 6707A of the Internal Revenue Code of 1986, and

(2) a description of each penalty rescinded under section 6707(c) of such Code and the reasons therefor." Pub. L. No. 108-357, Title VIII, Subtitle B, Part I, § 811(d), 118 Stat. 1577, Oct. 22, 2004.

Explanation of Provision

The provision requires that the IRS, in consultation with the Secretary, submit an annual report on administration of certain penalty provisions of the Code to the House Committee on Ways and Means and the Senate Committee on Finance. A summary of penalties assessed the preceding year is required. In addition, the Secretary must report actions taken against practitioners appearing before the Treasury or IRS with respect to a reportable transaction[48] and instances in which the IRS attempted to rely on the exception to the limitations period for assessment based on failure to disclose a listed transaction.[49] The penalties that are subject to this reporting requirement are those assessed in the preceding year with respect to (1) a participant's failure to disclose a reportable transaction,[50] (2) reportable transaction understatements,[51] (3) promotion of abusive shelters,[52] (4) failure of a material advisor to furnish information on a reportable transaction,[53] and (5) material advisors' failure to maintain or produce a list of reportable transactions.[54]

Effective Date

The first annual report is required to be submitted not later than December 31, 2010.

[48] 31 U.S.C. sec. 330(b) authorizes the Secretary to impose sanctions on those who appear before the Department, including monetary penalties and suspension or disbarment from practice before the Department.

[49] Sec. 6501(c)(10) provides that the limitations period with respect to tax attributable to a listed transaction shall not expire less than one year after the required disclosure of that transaction is furnished by the taxpayer or by the material advisor, whichever is earlier.

[50] Sec. 6707A.

[51] Sec. 6662A.

[52] Sec. 6700.

[53] Sec. 6707.

[54] Sec. 6708.

C. Other Provisions

1. Increase in amount allowed as deduction for start-up expenditures (sec. 521 of the bill and sec. 195 of the Code)

Present Law

A taxpayer can elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins.[55] However, the $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds $50,000.[56] Start-up expenditures that are not deductible in the year in which the active trade or business begins are, at the taxpayer's election, amortized over a 15-year period beginning with the month the active trade or business begins.[57] Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began.[58]

Treasury regulations[59] provide that a taxpayer is deemed to have made an election under section 195(b) to amortize its start-up expenditures for the taxable year in which the active trade or business to which the expenditures relate begins. A taxpayer that chooses to forgo the deemed election must clearly elect to capitalize its start-up expenditures on its timely filed Federal income tax return for the taxable year the active trade or business commences. The election either to amortize or capitalize start-up expenditures is irrevocable and applies to all start-up expenditures related to the active trade or business.

Explanation of Provision

For taxable years beginning in 2010 or 2011, the provision increases the amount of start-up expenditures a taxpayer can elect to deduct from $5,000 to $20,000. The provision also increases the deduction phase-out threshold such that the $20,000 is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds $75,000.

Effective Date

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

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[55] Sec. 195(b)(1)(A).

[56] Ibid.

[57] Sec. 195(b)(1)(B).

[58] Sec. 195(c).

[59] Temp. Treas. Reg. sec. 1.195-1T(b).

2. Nonrecourse small business investment company loans from the Small Business Administration treated as amounts at risk (sec. 522 of the bill and sec. 465 of the Code)

Present Law

Several present-law rules limit losses from business activities held by individuals, including activities held through partnerships. Under present law, the character of partnership items passes through to the partners as if the items were realized directly by the partners. A partner's share of partnership loss is allowed only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the year in which the loss occurred.[60] The basis of a partnership interest generally includes the amount contributed by the partner to the partnership, and for this purpose, generally an increase in the partner's share of partnership liabilities (including debt) is considered as a contribution by the partner.[61]

In the case of individuals and closely held corporations, present law includes rules designed to prevent the deduction of losses exceeding the taxpayer's economic investment − the at-risk rules[62] − and to limit tax shelters.[63]

Present law provides an at-risk limitation on losses from an activity engaged in by the taxpayer in carrying on a trade or business or for the production of income (including through a partnership), in the case of taxpayers that are individuals or certain closely held corporations. A taxpayer is generally not considered at risk with respect to borrowed amounts if (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans), or (2) the lender has an interest (other than as a creditor) in the activity.[64] In the case of the activity of holding real property, a special rule treats qualified nonrecourse financing as an amount at risk.[65] Qualified

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[60] Sec. 704(d).

[61] Secs. 722, 752.

[62] Sec. 465.

[63] The passive loss rules limit deductions and credits from passive trade or business activities of individuals and certain closely held corporations (sec. 469, enacted in 1986). A passive activity is generally an activity in which the taxpayer does not materially participate, and certain rental real estate activities regardless of the taxpayer's material participation. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

[64] Sec. 465(b).

[65] In its Reasons for Change in adopting the extension of the at-risk rules to real estate and providing an exception for qualified nonrecourse financing for real estate, the House Committee on Ways and Means stated, "Nonrecourse financing by the seller of real property (or a person related to the seller) is not treated as an amount at risk under the bill, because there may be little or no incentive to limit the amount of such financing to the value of the property. In the case of arm's length third party commercial financing secured solely by the real property, however, the lender is much less likely to make loans which exceed the property's value or which cannot be serviced by the property; it is more likely that such financing will be repaid and that the purchaser consequently has or will

nonrecourse financing generally includes financing that is secured by real property used in the activity and that is loaned by or guaranteed by a Federal, State, or local government, or is borrowed by the taxpayer from a qualified person that is or is treated as a person actively and regularly engaged in the business of lending money (such as a bank). Any loss not allowed under this rule for a taxable year is carried forward to the succeeding taxable year. A taxpayer's amount at risk is reduced by losses allowed under the rule.

Explanation of Provision

The provision modifies the at-risk rules. The bill provides that a taxpayer's amount at risk includes qualified SBIC financing, which means any financing that (1) is borrowed by a small business investment company (SBIC), (2) is secured by property held, directly or indirectly, by the SBIC, and (3) is either borrowed from, or guaranteed by, the Small Business Administration under the authority of its SBIC program (section 303(b) of the Small Business Investment Act of 1958, as amended).[66]

Effective Date

The provision is effective for loans and guarantees made after the date of enactment.

3. Benefits under the Small Business Borrower Assistance Program excluded from gross income (sec. 523 of the bill and new sec. 139F of the Code)

Present Law

Present law generally provides that gross income includes all income from whatever source derived.[67] However, the Code includes several exceptions to this general rule for various items Congress has determined should be excluded from gross income.[68]

Explanation of Provision

The provision excludes from gross income any amount paid on behalf of a borrower by the Small Business Administration under the Small Business Borrower Assistance program as established under section 402 of the Small Business Assistance Fund Act of 2010 (as in effect immediately after the date of the enactment of such Act). No deduction is allowed for interest to the extent the liability for the interest is covered by the payment. If all or a portion of the

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have real equity in the activity." H. Rep. No. 99-426, Tax Reform Act of 1985, *Report of the Committee on Ways and Means, House of Representatives, on H.R. 3838*, December 7, 1985, at 293; and see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Cong., Pub. L. No. 99-514)*, JCS-10-87, May 4, 1987, at 257.

[66] Pub. L. No. 85-699.

[67] Sec. 61.

[68] See sections 101-139D.

payment is applied to reduce principal of the loan,[69] the payment is allocated pro rata among expenditures financed by such loan. To the extent of the amount of the payment allocated to such expenditures, no deduction or credit is allowed, and the basis of any property acquired is reduced.

Effective Date

The provision is effective for payments made after the date of enactment.

[69] It is intended that the payment is allocated between interest and principal consistent with the actual application of the payment.

II. REVENUE PROVISIONS

A. Require Minimum 10-Year Term and Other Modifications for Qualification of Grantor Retained Annuity Trusts (GRATs) (sec. 531 of the bill and sec. 2702 of the Code)

Present Law

Overview

Present law provides special rules for valuing certain transfers in trust of temporal interests in property (such as annuity interests and remainder interests).[70] Present law also provides rules for determining when a grantor of a trust will be treated as the owner of all or part of the trust for income tax purposes.[71] A grantor retained annuity trust ("GRAT"), often structured as grantor-owned, is a vehicle that is used to make transfers of temporal interests in property.

Valuation of certain transfers in trust

In the event of a lifetime transfer in trust to (or for the benefit of) a member of the transferor's family where the transferor or an applicable family member retains any interest in the trust, a special rule applies for purposes of determining the value of the transferor's gift.[72] In general, the value of any retained interest that is not a "qualified interest" is treated as zero.[73] Therefore, where a transferor retains an interest that is not a qualified interest, the entire amount transferred to the trust generally is treated as a gift by the transferor to the remainder beneficiaries, which gift is subject to transfer taxation.[74] The value of a retained interest that is a qualified interest, on the other hand, is determined using rates and procedures described in the Code for valuing temporal interests in property.[75]

For these purposes, the term "qualified interest" means: (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually (i.e., a qualified annuity interest); (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually) (i.e., a qualified unitrust interest); and (3) any

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[70] See sec. 2702.

[71] See secs. 671-679.

[72] Sec. 2702(a)(1).

[73] Sec. 2702(a)(2)(A).

[74] The special valuation rule does not apply in certain excepted situations, including: (1) where the transfer is not a completed gift; and (2) transfers to certain personal residence trusts. See sec. 2702(a)(3).

[75] Sec. 2702(a)(2)(B); sec. 7520.

noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2) (i.e., a qualified remainder interest).[76]

A qualified interest is valued under procedures described in section 7520 using tables prescribed by the Secretary of the Treasury and an interest rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the Federal midterm interest rate in effect under section 1274(d)(1) for the month in which the valuation date falls. The tables and rates described in section 7520 assume that the assets in a trust will grow at a relatively modest rate.

<u>**"Grantor trust" rules**</u>

For income tax purposes, a trust generally is a separate taxpayer. Under certain circumstances, however, a grantor is treated as the owner of all or part of a trust for income tax purposes.[77] When a grantor is treated as owner of a trust, the grantor, when computing his or her taxable income and credits, generally must include items of income, deductions, and credits of the trust attributable to the portion of the trust deemed owned by the grantor for income tax purposes.[78]

The Code includes a number of rules regarding when a grantor or another person is treated as the owner of all or part of a trust for income tax purposes.[79] A grantor may, for example, be treated as the owner of a trust for income tax purposes where the grantor has: (1) a sufficient reversionary interest in the corpus or income of the trust;[80] (2) the power to control beneficial enjoyment of the corpus or income of the trust;[81] (3) certain administrative powers;[82] (4) the power to revoke all or part of the trust;[83] or (5) the power to distribute income to or for the benefit of the grantor.[84]

A trust that is structured such that the grantor is treated as the owner for income tax purposes, but not for gift or estate tax purposes, is sometimes referred to as an "intentionally defective grantor trust."

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[76] Sec. 2702(b).

[77] See secs. 671-679.

[78] See sec. 671.

[79] See secs. 673-677.

[80] Sec. 673.

[81] Sec. 674.

[82] Sec. 675.

[83] Sec. 676.

[84] Sec. 677.

Grantor retained annuity trusts

A GRAT generally is an irrevocable trust in which the grantor retains an annuity interest structured as a "qualified interest" under section 2702. The annuity interest must be an irrevocable right to receive a fixed amount at least annually.[85] The trustee must be required to invade the principal of the trust in the event the income is insufficient to pay the qualified annuity.

Assuming the transfer of assets to the trust is treated as a completed gift for gift tax purposes, the gift to the remainder beneficiaries generally will be subject to gift tax as of the time of the initial transfer of assets to the trust. Therefore, the grantor will be required to use a portion of his or her gift tax exemption equal to − or, to the extent insufficient exemption remains, to pay gift tax on − the value of the remainder interest determined as of the time the grantor funds the trust. The annuity portion of a GRAT is valued using the procedures for valuing qualified interests outlined in section 7520 (described above). To value the remainder interest in a GRAT, the value of any qualified interest, as determined under section 7520, is subtracted from the value of the property transferred to the trust.

When the grantor's retained annuity interest expires, the trust assets are distributed to one or more remainder beneficiaries identified in the trust instrument. Because the value of the transferor's gift for gift tax purposes is determined at the time of the transfer, if trust property grows at a rate in excess of the growth rate assumed under section 7520, the excess appreciation generally will pass to the remainder beneficiaries without further gift tax consequences to the grantor. If, however, the grantor dies during the trust term, that portion of the trust necessary to generate the annuity amount will be included in the grantor's gross estate for estate tax purposes.[86] Such inclusion generally results in the loss of the transfer tax benefit of using a GRAT.

A GRAT is a grantor trust; therefore, the grantor is treated as owner of the trust during the term of the annuity interest, and the grantor generally must include in determining his or her taxable income and credits the income, deductions, and credits of the trust.

Explanation of Provision

The provision adds certain requirements for an annuity interest retained by the transferor to be treated as a qualified interest for purposes of the special valuations rules applicable to transfers of a trust interest to a member of the transferor's family: (1) the retained annuity interest must have a term not less than 10 years; (2) the annuity (determined on an annual basis) may not decline during the first 10 years of the annuity term; and (3) the remainder interest must have a value greater than zero at the time of the transfer.

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[85] Treas. Reg. sec. 25.2702-3(b).

[86] Sec. 2036.

Effective Date

The provision applies to transfers made after the date of enactment.

B. Crude Tall Oil Ineligible for the Cellulosic Biofuel Producer Credit (sec. 532 of the bill and sec. 40 of the Code)

Present Law

The "cellulosic biofuel producer credit" is a nonrefundable income tax credit for each gallon of qualified cellulosic biofuel production of the producer for the taxable year. The amount of the credit is generally $1.01 per gallon.[87]

"Qualified cellulosic biofuel production" is any cellulosic biofuel which is produced by the taxpayer and which is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified cellulosic biofuel 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 cellulosic biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).

"Cellulosic biofuel" means any liquid fuel that (1) is produced in the United States and used as fuel in the United States, (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act.[88] The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of cellulosic biofuel.

Cellulosic biofuel does not include certain unprocessed fuel. Unprocessed fuels are fuels which (1) are more than four percent (determined by weight) water and sediment in any combination, or (2) have an ash content of more than one percent (determined by weight).[89] Cellulosic biofuel eligible for the section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.[90]

Because it is a credit under section 40(a), the cellulosic biofuel producer credit is part of the general business credits in section 38. However, unlike other general business credits, the

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[87] In the case of cellulosic biofuel that is alcohol, the $1.01 credit amount is reduced by the credit amount of the alcohol mixture credit, and for ethanol, the credit amount for small ethanol producers, as in effect at the time the cellulosic biofuel fuel is produced.

[88] 42 U.S.C. sec. 7545.

[89] Water content (including both free water and water in solution with dissolved solids) is determined by distillation, using for example ASTM method D95 or a similar method suitable to the specific fuel being tested. Sediment consists of solid particles that are dispersed in the liquid fuel and is determined by centrifuge or extraction using, for example, ASTM method D1796 or D473 or similar method that reports sediment content in weight percent. Ash is the residue remaining after combustion of the sample using a specified method, such as ASTM D3174 or a similar method suitable for the fuel being tested.

[90] See secs. 40A(d)(1), 40A(f)(3), and 6426(h).

cellulosic biofuel producer credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under section 87, the credit is included in gross income. The cellulosic biofuel producer credit terminates on December 31, 2012.

The kraft process for making paper produces a byproduct called black liquor, which has been used for decades by paper manufacturers as a fuel in the papermaking process. Black liquor is composed of water, lignin and the spent chemicals used to break down the wood. The amount of the biomass in black liquor varies. The portion of the black liquor that is not consumed as a fuel source for the paper mills is recycled back into the papermaking process. Black liquor has ash content (mineral and other inorganic matter) significantly above that of other fuels.

Crude tall oil is generated by reacting acid with black liquor soap. Crude tall oil is used in various applications, such as adhesives, resins and inks. It also can be burned and used as a fuel.

Explanation of Provision

The provision modifies the cellulosic biofuel producer credit to exclude from the definition of cellulosic biofuel fuels with an acid number of greater than 25. The acid number is the amount of base required to neutralize the acid in the sample. The acid number is reported as weight of the base (typically potassium hydroxide) per weight of sample, or milligram ("mg") potassium hydroxide per gram. The normal acid number for crude tall oil is between 100 and 175. As a comparison, ASTM D6751 for biodiesel specifies that the acid number be less than 0.5mg potassium hydroxide. ASTM D4806 for ethanol does not have acid value but instead limits "acidity" to 0.007 mg of acetic acid per liter, which is significantly below an acid number of 25.

Effective Date

The provision is effective for fuels sold or used on or after January 1, 2010.

C. Time for Payment of Corporate Estimated Taxes (sec. 533 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.[91] 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;[92]

(ii) payments due in July, August or September, 2015, are increased to 121.5 percent of the payment otherwise due;[93] and

(iii) payments due in July, August or September, 2019, are increased to 106.5 percent of the payment otherwise due.[94]

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 7.75 percentage points.

Effective Date

The provision is effective on the date of enactment of the bill.

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[91] Sec. 6655.

[92] 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).

[93] Pub. L. No. 111-147, Sec. 561, par. (2).

[94] Pub. L. No. 111-147, Sec. 561, par. (3).