

**DESCRIPTION OF THE CHAIRMAN'S MODIFICATION  
OF THE PROVISIONS OF THE  
"SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007"**

Scheduled for Markup  
by the  
SENATE COMMITTEE ON FINANCE  
on January 17, 2007

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



January 17, 2007  
JCX-5-07

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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the provisions of the "Small Business and Work Opportunity Act of 2007," which is to be marked up by the Senate Committee on Finance on January 17, 2007.<sup>2</sup>

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "Small Business and Work Opportunity Act of 2007"* (JCX-5-07) January 17, 2007.

<sup>2</sup> The provisions of the Chairman's mark are described in the Joint Committee on Taxation, *Description of the Chairman's Mark of the "Small Business and Work Opportunity Act of 2007"* (JCX-3-07), January 12, 2007.

## **I. MODIFICATION TO THE CHAIRMAN'S MARK**

### **A. Modification to Treatment of Bank Director Shares (Item I.F.2 of the Chairman's Mark)**

The requirement that a financial institution be registered with the Federal Reserve System in order for its stock to qualify as bank director shares is deleted.

## **II. PROPOSALS THAT RAISE REVENUE**

### **A. Modification of Effective Date of Leasing Provisions of the American Jobs Creation Act of 2004**

#### **Present Law**

Present law provides for the deferral of losses attributable to certain tax exempt use property, generally effective for leases entered into after March 12, 2004. The deferral provision does not apply to property located in the United States that is subject to a lease with respect to which a formal application: (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004; (2) is approved by the Federal Transit Administration before January 1, 2006; and (3) includes a description and the fair market value of such property (the “qualified transportation property exception”).

#### **Description of Proposal**

The proposal changes the effective date of the loss deferral rules with respect to certain leases. Under the proposal, the loss deferral rules also apply to leases entered into on or before March 12, 2004, if the lessee is a foreign person or entity. With respect to such leases, losses are deferred starting in taxable years beginning after December 31, 2006.

#### **Effective Date**

The proposal is effective as if included in the provisions of the American Jobs Creation Act of 2004 to which it relates.

## **B. Tax Treatment of Certain Inverted Corporate Entities**

### **Present Law**

#### **Determination of corporate residence**

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. Other corporations (i.e., those incorporated under the laws of foreign countries or U.S. possessions) generally are treated as foreign.

#### **U.S. taxation of domestic corporations**

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the double taxation that may arise from taxing the foreign-source income of a domestic corporation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether such income is repatriated as an actual dividend or included under one of the anti-deferral regimes.

#### **U.S. taxation of foreign corporations**

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is “effectively connected” with the conduct of a trade or business in the United States. Such “effectively connected income” generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a “permanent establishment” in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

## **U.S. tax treatment of inversion transactions prior to the American Jobs Creation Act of 2004**

Prior to the American Jobs Creation Act of 2004 (“AJCA”), a U.S. corporation could reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions were commonly referred to as inversion transactions. Inversion transactions could take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions were stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation’s shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion could be used to reach a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction could be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation could transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from U.S. taxing jurisdiction, the corporate group could seek to derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This could include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure could enable the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

Inversion transactions could give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognized gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation’s share value had declined, and/or it had many foreign or tax-exempt shareholders, the impact of this section 367(a) “toll charge” was reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also could give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under secs. 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings could be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognized gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally did not recognize gain or loss, assuming the transaction met the requirements of a reorganization under section 368.

## **U.S. tax treatment of inversion transactions under AJCA**

### In general

AJCA added new section 7874 to the Code, which defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

### Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan<sup>3</sup> or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion (“80-percent inversion”) by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.<sup>4</sup>

In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called “hook” stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded, with the result that the transaction would not meet the definition of an inversion under the provision. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is to provide regulations to carry out the provision, including regulations to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed

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<sup>3</sup> Acquisitions with respect to a domestic corporation or partnership are deemed to be “pursuant to a plan” if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

<sup>4</sup> Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level “toll charge” of sec. 367(a) does not apply to these inversion transactions.



to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary has the authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

#### Transactions involving at least 60 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level “toll charges” for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

#### Other rules

Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified “toll charge” rules apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

### **Description of Proposal**

The proposal generally extends the 80-percent inversion regime of section 7874 to 80-percent inversions completed after March 20, 2002 but on or before March 4, 2003, with certain modifications as described below. A transaction otherwise meeting the definition of an 80-percent inversion under the proposal (i.e., one completed after March 20, 2002 but on or before March 4, 2003) is not treated as an 80-percent inversion if, on or before March 20, 2002, the foreign-incorporated entity had acquired directly or indirectly more than half the properties held

directly or indirectly by the domestic corporation, or more than half the properties constituting the partnership trade or business, as the case may be.

Under the proposal, an 80-percent inversion that is completed after March 20, 2002 but on or before March 4, 2003 is respected until the end of the last day of the foreign-incorporated entity's taxable year that began in 2006. At the end of that day, the inverted foreign-incorporated entity that completed the 80-percent inversion (or if relevant, any successor entity) is deemed to have transferred all of its assets and liabilities to a domestic corporation in a transaction that is generally treated as a nontaxable inbound reorganization ("repatriation"). The basis of the assets of the foreign-incorporated entity generally remains the same in the hands of the domestic corporation, subject to any special adjustments for importing built-in losses (e.g., sec. 362(e)). Shareholders of the domestic corporation inherit the respective bases of their shares of the foreign-incorporated entity.

On the day of the repatriation, the earnings and profits of the inverted foreign-incorporated entity transfer over to the domestic corporation. The transfer of such earnings and profits is not a deemed dividend and does not result in a tax upon the domestic corporation or its shareholders. In addition, any foreign taxes attributable to such earnings and profits are not creditable. However, shareholders may be subject to tax on distributions of such earnings and profits.

Beginning on the day after the repatriation, the inverted foreign-incorporated entity is treated for all tax purposes as a domestic corporation. Thus, any income earned by the inverted foreign-incorporated entity after the date of repatriation is deemed to be earned by a domestic corporation, and therefore, is fully taxable at U.S. corporate income tax rates. As a further consequence of the repatriation of the inverted foreign-incorporated entity, foreign subsidiaries become controlled foreign corporations, subject to the rules of subpart F.

It is intended that the Secretary will prescribe regulations that are necessary or appropriate to carry out the proposal, including, but not limited to, regulations to prevent the avoidance of the purposes of the proposal.

#### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2006.

## **C. Denial of Deduction for Punitive Damages**

### **Present Law**

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.<sup>5</sup> However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.<sup>6</sup> In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.<sup>7</sup> Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.<sup>8</sup>

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.<sup>9</sup> However, this exclusion does not apply to punitive damages.<sup>10</sup>

### **Description of Proposal**

The proposal denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

### **Effective Date**

The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment.

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<sup>5</sup> Sec. 162(a).

<sup>6</sup> Sec. 162(c).

<sup>7</sup> Sec. 162(f).

<sup>8</sup> Sec. 162(g).

<sup>9</sup> Sec. 104(a).

<sup>10</sup> Sec. 104(a)(2).

## **D. Denial of Deduction for Certain Fines, Penalties, and Other Amounts**

### **Present Law**

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that “allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof.”<sup>11</sup>

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer’s actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

### **Description of Provision**

The provision modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the provision generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law<sup>12</sup> are nondeductible under any provision of the income tax provisions.<sup>13</sup> The provision applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property), or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, and that are identified in the court order or settlement as restitution, remediation, or

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<sup>11</sup> S. Rep. No. 91-552, 91<sup>st</sup> Cong, 1<sup>st</sup> Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

<sup>12</sup> The provision does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the provision would affect that payment.

<sup>13</sup> The provision provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

required to come into compliance.<sup>14</sup> The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made.<sup>15</sup>

An exception also applies to any amount paid or incurred as taxes due.<sup>16</sup>

The provision is intended to apply only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law.<sup>17</sup>

It is intended that a payment will be treated as restitution (including remediation of property) only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution or included remediation of property.<sup>18</sup> Restitution and included remediation of property is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution and included remediation of property includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution or included remediation of property does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

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<sup>14</sup> The provision does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which continue to be governed by the provisions of section 162(g).

<sup>15</sup> If a settlement agreement does not specify a specific amount to be paid for the purpose of coming into compliance but instead simply requires the taxpayer to come into compliance, it is sufficient identification to so state. Amounts expended by the taxpayer for that purpose would then be considered identified. However, if an agreement specifies a specific dollar amount that must be paid or incurred, the amount would not be eligible to be deducted without a specification that it is for restitution (including remediation of property), or coming into compliance.

<sup>16</sup> Thus, amounts paid or incurred as taxes due are not affected by the provision (e.g., State taxes that are otherwise deductible). The reference to taxes due is also intended to include interest with respect to such taxes (but not interest, if any, with respect to any penalties imposed with respect to such taxes).

<sup>17</sup> Thus, for example, the provision would not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause a payment to be made “at the direction of a government” for purposes of the provision.

<sup>18</sup> Similarly, a payment to a charitable organization benefiting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the provision, such a payment not deductible under section 162 would also not be deductible under section 170.

It is intended that a payment will be treated as an amount required to come into compliance only if it directly corrects a violation with respect to a particular requirement of law that was under investigation. For example, if the law requires a particular emission standard to be met or particular machinery to be used, amounts required to be paid under a settlement agreement to meet the required standard or install the machinery are deductible to the extent otherwise allowed. Similarly, if the law requires certain practices and procedures to be followed and a settlement agreement requires the taxpayer to pay to establish such practices or procedures, such amounts would be deductible. However, amounts paid for other purposes not directly correcting a violation of law are not deductible. For example, amounts paid to bring other machinery that is already in compliance up to a standard higher than required by the law, or to create other benefits (such as a park or other action not previously required by law), are not deductible if required under a settlement agreement. Similarly, amounts paid to educate consumers or customers about the risks of doing business with the taxpayer or about the field in which the taxpayer does business generally, which education efforts are not specifically required under the law, are not deductible if required under a settlement agreement.

The provision requires government agencies to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered where the aggregate amount required to be paid or incurred to or at the direction of the government under such settlement agreements and orders with respect to the violation, investigation, or inquiry is least \$600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The reports must be made within 30 days of the date the court order is issued or the settlement agreement is entered into, or such other time as may be required by Secretary. The report must separately identify any amounts that are restitution or remediation of property, or correction of noncompliance.<sup>19</sup>

The IRS is encouraged to require taxpayers to identify separately on their tax returns the amounts of any such settlements with respect to which reporting is required under the provision, including separate identification of the nondeductible amount and of any amount deductible as restitution, remediation, or required to correct noncompliance.<sup>20</sup>

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory

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<sup>19</sup> As in the case of the identification requirement, if the agreement does not specify a specific amount to be expended to come into compliance but simply requires that to occur, it is expected that the report may state simply that the taxpayer is required to come into compliance but no specific dollar amount has been specified for that purpose in the settlement agreement.

<sup>20</sup> For example, the IRS might require such separate reporting as part of, or in addition to, reporting of amounts that are not deducted and that thus create a book tax difference on the schedule M-3.

powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are paid or incurred for restitution, remediation of property, or coming into compliance and that are identified as such in the order or settlement agreement likewise applies in these cases. The requirement of reporting to the IRS and the taxpayer also applies in these cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the provision is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

#### **Effective Date**

The provision is effective for amounts paid or incurred on or after the date of enactment; however the provision does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained before the date of enactment.

## **E. Revision of Tax Rules on Expatriation of Individuals**

### **Present Law**

#### **In general**

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States), but excluding intangibles, such as stock, regardless of where they are located.

#### **Income tax rules with respect to expatriates**

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. long-term residency, unless certain conditions are met, the individual is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the “alternative tax regime”). Generally, the individual is subject to income tax for the 10-year period at the rates applicable to U.S. citizens, but only on U.S.-source income.<sup>21</sup>

A “long-term resident” is a noncitizen who is a lawful permanent resident of the United States for at least eight taxable years during the period of 15 taxable years ending with the taxable year during which the individual either ceases to be a lawful permanent resident of the United States or commences to be treated as a resident of a foreign country under a tax treaty between such foreign country and the United States (and does not waive such benefits).

A former citizen or former long-term resident is subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed \$124,000 (adjusted for inflation after 2004) and his or her net worth is less than \$2 million, or alternatively satisfies limited, objective exceptions for certain dual citizens and minors who have had no substantial contacts with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

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<sup>21</sup> For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.



### **Estate tax rules with respect to expatriates**

Special estate tax rules apply to individuals who die during a taxable year in which he or she is subject to the alternative tax regime. Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets. The special rules apply if, at the time of death: (1) the former citizen or former long-term resident directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then the gross estate of the former citizen or former long-term resident includes that proportion of the fair market value of the foreign stock owned by the individual at the time of death, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of death) bears to the total fair market value of all assets owned by such foreign corporation (at the time of death).

### **Gift tax rules with respect to expatriates**

Special gift tax rules apply to individuals who make gifts during a taxable year in which he or she is subject to the alternative tax regime. The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination. In addition, gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident are subject to gift tax, if the gift is made during the time that such person is subject to the alternative tax regime. The operative rules with respect to these gifts of closely-held foreign stock are the same as described above relating to the estate tax, except that the relevant testing and valuation date is the date of gift rather than the date of death.

### **Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes**

An individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement to the Secretary of the Treasury in accordance with section 6039G.

### **Sanction for individuals subject to the individual tax regime who return to the United States for extended periods**

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and, therefore, is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes<sup>22</sup> generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States<sup>23</sup> and individuals with minimal prior physical presence in the United States,<sup>24</sup> a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

### **Annual return**

Former citizens and former long-term residents are required to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate and gift tax rules.

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<sup>22</sup> Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

<sup>23</sup> An individual has such a relationship to a foreign country if (1) the individual becomes a citizen or resident of the country in which the individual was born, such individual's spouse was born, or either of the individual's parents was born, and (2) the individual becomes fully liable for income tax in such country.

<sup>24</sup> An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, for purposes of this test, an individual is not treated as being present in the United States on a day if the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of \$10,000. The \$10,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

## **Description of Proposal**

### **In general**

The proposal generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination (“mark-to-market tax”). Gain from the deemed sale is taken into account at that time without regard to other Code provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code, except that the wash sale rules of section 1091 do not apply. Any net gain on the deemed sale is recognized to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The \$600,000 amount is increased by a cost of living adjustment factor for calendar years after 2005.

### **Individuals covered**

The mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency (collectively, “covered expatriates”). The definition of “long-term resident” under the proposal is the same as that under present law. As under present law, an individual is considered to terminate long-term residency when the individual either ceases to be a lawful permanent resident (i.e., loses his or her green card status), or is treated as a resident of another country under a tax treaty and does not waive the benefits of the treaty.

Exceptions to an individual’s classification as a covered expatriate are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18½, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

For purposes of the mark-to-market tax, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of

nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

In addition, the proposal provides that, for all tax purposes (i.e., not limited to the mark-to-market tax), a U.S. citizen continues to be treated as a U.S. citizen for tax purposes until that individual's citizenship is treated as relinquished under the rules of the immediately preceding paragraph. However, under Treasury regulations, relinquishment may occur earlier with respect to an individual who became at birth a citizen of the United States and of another country.

### **Election to be treated as a U.S. citizen**

Under the proposal, a covered expatriate is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an "all or nothing" election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, applies to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, following expatriation the individual continues to pay U.S. income taxes at the rates applicable to U.S. citizens on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property continues to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer is required to waive any treaty rights that would preclude the collection of the tax.

The individual is also required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) becomes a lien in favor of the United States on all U.S.-situated property owned by the individual. This lien arises on the expatriation date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary of the Treasury is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

### **Deemed sale of property upon expatriation or residency termination and tentative tax**

The deemed sale rule of the proposal generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests (which remain subject to U.S. tax in the hands of nonresident noncitizens), with the exception of stock of certain former U.S. real property holding corporations, are exempted from the proposal. Regulatory authority is granted to the Treasury to exempt other types of property from the proposal.

Under the proposal, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquishes citizenship or terminates residency. Thus, the

tentative tax is based on all income, gains, deductions, losses, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. Moreover, notwithstanding any other provision of the Code, any period during which recognition of income or gain had been deferred terminates on the day before relinquishment of citizenship or termination of residency (and, therefore, such income or gain recognition becomes part of the tax base of the tentative tax). The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency, subject to the election, described below, to defer payments of the mark-to-market tax. In addition, notwithstanding any other provision of the Code, any extension of time for payment of tax ceases to apply on the day before relinquishment of citizenship or termination of residency, and the unpaid portion of such tax becomes due and payable at the time and in the manner prescribed by the Secretary of the Treasury.

### **Deferral of payment of mark-to-market tax**

Under the proposal, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. The election is irrevocable and is made on a property-by-property basis. Under the election, the deferred tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in a transaction in which gain is not recognized in whole or in part, at such other time as the Secretary of the Treasury may prescribe). The deferred tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax as the gain taken into account with respect to such property bears to the total gain taken into account under these rules. The deferral of the mark-to-market tax may not be extended beyond the due date of the return for the taxable year which includes the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide a bond in the amount of the deferred tax to the Secretary of the Treasury. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred tax amount (including any interest, penalties, and certain other items) becomes a lien in favor of the United States on all U.S.-situated property owned by the individual. This lien arises on the expatriation date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to such liens.

## **Retirement plans and similar arrangements**

Subject to certain exceptions, the proposal applies to all property interests held by covered expatriates at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored qualified plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).<sup>25</sup> However, the proposal contains a special rule for an interest in a “retirement plan.” For purposes of the proposal, a “retirement plan” includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), an individual retirement account (sec. 408(a)), and an individual retirement annuity (sec. 408(b)). The special retirement plan rule also applies, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a retirement plan is subject to the special retirement plan rules and not to the rules for interests in trusts (discussed below).

Under the special retirement plan rules, in lieu of the deemed sale rule, an amount equal to the present value of the individual’s vested, accrued benefit under a retirement plan is treated as having been received by the individual as a distribution under the retirement plan on the day before the individual’s relinquishment of citizenship or termination of residency. In the case of any later distribution to the individual from the retirement plan, the amount otherwise includible in the individual’s income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule, over (2) the total reductions applied to any prior distributions. It is not intended that the retirement plan would be deemed to have made a distribution at the time of expatriation for purposes of the tax-favored status of the retirement plan, such as whether a plan may permit distributions before a participant has severed employment. However, the retirement plan, and any person acting on the plan’s behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual’s vested, accrued benefit under a retirement plan, such as the individual’s account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

## **Interests in trusts**

Detailed rules apply under the proposal to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a “qualified trust.” A trust is a qualified trust if a court within the

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<sup>25</sup> Application of the proposal is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

#### Nonqualified trusts

If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets for their fair market value on the day before the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. Any income, gain, or loss of the individual arising from the deemed distribution from the trust is taken into account as if it had arisen under the deemed sale rules.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, historical patterns of trust distributions, and the existence of, and function performed by, a trust protector or any similar advisor.

#### Qualified trusts

If an individual has an interest in a qualified trust, the amount of mark-to-market tax on unrealized gain allocable to the individual's trust interest ("allocable expatriation gain") is calculated at the time of expatriation or residency termination, but is collected as the individual receives distributions from the qualified trust. The allocable expatriation gain is the amount of gain which would be allocable to the individual's trust interest if the individual directly held all the assets allocable to such interest.<sup>26</sup> If any individual's interest in a trust is vested as of the day before the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all

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<sup>26</sup> Allocable expatriation gain is subject to the \$600,000 exemption (adjusted for cost of living increases).

contingencies and discretionary powers in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive).

Taxes are imposed on each distribution from a qualified trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates for the taxable year which includes the date of expatriation, but in no event will the tax imposed exceed the balance in the "deferred tax account" with respect to the trust interest. For this purpose, the balance in the deferred tax account is equal to (1) the hypothetical tax calculated under the "regular" deemed sale rules with respect to the allocable expatriation gain, (2) increased by interest charged on the balance in the deferred tax account at a rate two percentage points higher than the rate normally applicable to individual underpayments, for periods beginning after the 90th day after the expatriation date and calculated up to 30 days prior to the date of the distribution, (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual, and (4) to the extent provided in Treasury regulations, in the case of a covered expatriate holding a nonvested interest, reduced by mark-to-market taxes imposed on trust distributions to other persons holding nonvested interests.

The tax that is imposed on distributions from a qualified trust generally is to be deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax.

Mark-to-market taxes become due immediately if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the balance in the deferred tax account with respect to the trust interest immediately before that date. Such tax is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual (or his or her estate) with respect to such tax.

### **Regulatory authority**

The proposal authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal. In addition, the Secretary of the Treasury may provide for adjustments to the bases of assets in a trust or a deferred tax account, and the timing of such adjustments, to ensure that gain is taxed only once.

### **Income tax treatment of gifts and inheritances from a former citizen or former long-term resident**

Under the proposal, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a covered expatriate. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is



required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient takes a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return was filed, but no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be.

### **Coordination with present-law alternative tax regime**

The proposal provides a coordination rule with the present-law alternative tax regime. Under the proposal, the present-law expatriation income tax rules under section 877, and the special present-law expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (generally described above), do not apply to a covered expatriate whose expatriation or residency termination occurs on or after the date of enactment.

### **Information reporting**

Certain information reporting requirements under the law presently applicable to former citizens and former long-term residents (sec. 6039G) also apply for purposes of the proposal.

### **Immigration rules**

The proposal denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the proposal's expatriation tax rules (regardless of the subjective motive for expatriating). For this purpose, the proposal permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the proposal permits the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with the new tax rules, and to identify the items of any noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection apply to return information disclosed under this proposal.

### **Effective Date**

The proposal generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of enactment. The due date for tentative tax, however, may not occur before the 90th day after the date of enactment. The portion of the proposal relating to income taxes on gifts and inheritances is effective for gifts and inheritances received from former citizens or former long-term residents (or their estates) on or after the date of enactment, whose relinquishment of citizenship or residency termination occurs after such date. The portion of the proposal relating to immigration and disclosure with respect

to former citizens is effective with respect to individuals who relinquish citizenship on or after the date of enactment.

## **F. Limit Amounts of Annual Deferrals Under Nonqualified Deferred Compensation Plans**

### **Present Law**

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.<sup>27</sup> The requirements include rules relating to distributions, acceleration of benefits and funding. For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. In general, elections to defer compensation for a taxable year must be made not later than the close of the preceding taxable year. Section 409A does not include rules limiting the amount that may be deferred under a nonqualified deferred compensation plan.

A nonqualified deferred compensation plan generally includes any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) and an eligible deferred compensation plan (sec. 457(b)) is a qualified employer plan.

If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

### **Description of Proposal**

The proposal adds an additional requirement to the rules governing the income inclusion of amounts deferred under a nonqualified deferred compensation plan. Under the proposal, the annual aggregate amounts deferred under a nonqualified deferred compensation plan by an individual may not exceed the lesser of (1) \$1 million or (2) the individual's annualized includible compensation. If the requirement is not satisfied, the present-law sanctions for failure to satisfy section 409A apply. Thus, if the requirement is not satisfied, all amounts deferred under the nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If the requirements of the proposal are not satisfied, as under present law, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a

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<sup>27</sup> Code sec. 409A.

20-percent additional tax.<sup>28</sup> Aggregation rules apply as necessary to carry out the purposes of the proposal.

Annualized includible compensation is the average annual compensation for services performed for the employer sponsoring the deferred compensation plan (or a predecessor or related entity) that was includible in the individual's gross income for the five-year period preceding the year for which the limitation is being determined.<sup>29</sup> In the case in which an election to defer amounts is made, annualized includible compensation is the average annual compensation for services performed for the employer sponsoring the deferred compensation plan (or a predecessor or related entity) that was includible in the individual's gross income for the five-year period preceding the year in which the election to defer is made. The proposal applies to all amounts deferred under nonqualified deferred compensation plans (as defined under section 409A), including plans of both private and publicly-held corporations.

Earnings (whether actual or notional) attributable to nonqualified deferred compensation are treated as additional deferred compensation and are subject to the proposal. Earnings on amounts deferred in taxable years beginning before January 1, 2007, are not subject to the proposal. Future earnings (actual or notional) on amounts included in income under the proposal are includible in income as earned.

The proposal is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The proposal provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the purposes of proposal.

### **Effective Date**

The proposal is effective for amounts deferred in taxable years beginning after December 31, 2006. The proposal directs Treasury to issue guidance allowing existing outstanding deferral elections to be modified on or before December 31, 2007, in order to reduce deferrals for taxable years beginning after December 31, 2006, to the extent needed to comply with the proposal, without violating the requirements of section 409A.

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<sup>28</sup> These consequences apply under the provision to amounts deferred after the effective date of the provision.

<sup>29</sup> It is intended that annualized includible compensation is determined under rules similar to the rules relating to golden parachute payments (sec. 280G) except that no change in ownership or control is required.

## **G. Increase in Criminal Monetary Penalty Limitations for Fraud and Other Crimes**

### **Present Law**

#### **Attempt to evade or defeat tax**

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to \$100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$500,000.

#### **Willful failure to file return, supply information, or pay tax**

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code and who willfully fail to do so. Upon conviction, the Code provides that the penalty is up to \$25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$100,000.

#### **Fraud and false statements**

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to \$100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$500,000.

#### **Uniform sentencing guidelines**

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision; (b) for a felony,<sup>30</sup> \$250,000 for an individual or \$500,000 for an organization; or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code.<sup>31</sup> For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is \$250,000 or, if greater, twice the amount of gross gain from the offense.

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<sup>30</sup> Section 7206 states that making fraudulent or false statements under the Code is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. 3559(a)(5).

<sup>31</sup> In *United States v. Booker*, 543 U.S. 220 (2005), the Supreme Court held that mandatory application of the Federal Sentencing Guidelines is incompatible with the Sixth Amendment jury trial requirement. As a result of this decision, the Federal Sentencing Guidelines are effectively advisory, i.e., requiring a sentencing court to consider the sentencing ranges under the Guidelines, but permitting it to tailor a sentence in light of other statutory concerns.

## **Description of Proposal**

### **Attempt to evade or defeat tax**

The proposal increases the criminal penalty under section 7201 of the Code for individuals to \$500,000 and for corporations to \$1,000,000. The proposal increases the maximum prison sentence to ten years.

### **Willful failure to file return, supply information, or pay tax**

The proposal increases the criminal penalty under section 7203 of the Code for individuals from \$25,000 to \$50,000 and, in the case of an “aggravated failure to file” (defined as a failure to file a return for a period of three or more consecutive taxable years if the aggregated tax liability for such period is at least \$100,000), changes the crime from a misdemeanor to a felony and increases the maximum prison sentence to ten years.

### **Fraud and false statements**

The proposal increases the criminal penalty for making fraudulent or false statements to \$500,000 for individuals and \$1,000,000 for corporations. The proposal increases the maximum prison sentence for making fraudulent or false statements to five years. The proposal provides that in no event shall the amount of the monetary penalty under the proposal be less than the amount of the underpayment or overpayment attributable to fraud.

## **Effective Date**

The proposal is effective for actions and failures to act occurring after the date of enactment.

## **H. Doubling of Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements**

### **Present Law**

#### **In general**

The Code contains numerous civil penalties, such as the delinquency, accuracy-related, fraud, and assessable penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the respective statutes of limitations for assessment and collection.

#### **Delinquency penalties**

##### **Failure to file**

Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. In the case of fraudulent failure to file, the penalty is increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 75 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

##### **Failure to pay**

Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If an income tax return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of \$100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

##### **Failure to make timely deposits of tax**

The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due

date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before earlier of 10 days after the date of the first delinquency notice to the taxpayer and 10 days after the date on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

### **Accuracy-related penalties**

#### **In general**

The accuracy-related penalties are imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant part, to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, and (4) any reportable transaction understatement. The penalty for a substantial valuation misstatement is doubled for certain gross valuation misstatements. In the case of a reportable transaction understatement for which the transaction is not disclosed, the penalty rate is 30 percent. These penalties are coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith, and in the case of a reportable transaction understatement the relevant facts of the transaction have been disclosed, there is or was substantial authority for the taxpayer's treatment of such transaction, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

#### **Negligence or disregard for the rules or regulations**

If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence means any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless, or intentional disregard of the rules or regulations.

#### **Substantial understatement of income tax**

Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year, or (2) \$5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.



### Substantial valuation misstatement

A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

### Reportable transaction understatement

A penalty applies to any item that is attributable to any listed transaction, or to any reportable transaction (other than a listed transaction) if a significant purpose of such reportable transaction is tax avoidance or evasion.

### **Fraud penalty**

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not apply to any portion of an underpayment on which the fraud penalty is imposed.

### **Assessable penalties**

In addition to the penalties described above, the Code imposes a number of additional penalties, including, for example, penalties for failure to file (or untimely filing of) information returns with respect to foreign trusts, and penalties for failure to disclose any required information with respect to a reportable transaction.

### **Interest provisions**

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

### **Offshore Voluntary Compliance Initiative**

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative (“OVCI”) to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in the OVCI, including sending a written request to participate in the program by April 15, 2003. This request

had to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. A taxpayer entering into a closing agreement under the OVCI is not liable for the civil fraud penalty, the fraudulent failure to file penalty, or the civil information return penalties. Such a taxpayer is responsible for back taxes, interest, and certain accuracy-related and delinquency penalties.<sup>32</sup>

### **Voluntary disclosure policy**

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.<sup>33</sup> The IRS treats participation in the OVCI as a voluntary disclosure.<sup>34</sup>

### **Description of Proposal**

The proposal doubles the amounts of civil penalties, interest, and fines related to taxpayers' underpayments of U.S. income tax liability through the direct or indirect use of certain offshore financial arrangements. The proposal applies to taxpayers who did not (or do not) voluntarily disclose such arrangements through the OVCI or otherwise. Under the proposal, the determination of whether any civil penalty is to be applied to such underpayment is made without regard to whether a return has been filed, whether there was reasonable cause for such underpayment, and whether the taxpayer acted in good faith.

The proscribed financial arrangements include, but are not limited to, the use of certain foreign leasing corporations for providing domestic employee services,<sup>35</sup> certain arrangements whereby the taxpayer may hold securities trading accounts through offshore banks or other financial intermediaries, certain arrangements whereby the taxpayer may access funds through the use of offshore credit, debit, or charge cards, and offshore annuities or trusts.

The Secretary of the Treasury is granted the authority to waive the application of the proposal if the use of the offshore financial arrangements is incidental to the transaction and, in

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<sup>32</sup> Rev. Proc. 2003-11, 2003-4 C.B. 311.

<sup>33</sup> Internal Revenue News Release 2002-135, IR-2002-135 (December 11, 2002).

<sup>34</sup> Rev. Proc. 2003-11, 2003-4 C.B. 311.

<sup>35</sup> These arrangements were described and classified as listed transactions in Notice 2003-22, 2003-1 C.B. 851.

the case of a trade or business, such use is conducted in the ordinary course of the type of trade or business in which the taxpayer is engaged.

### **Effective Date**

The proposal generally is effective with respect to a taxpayer's open tax years on or after the date of enactment.

## **I. Increase in Penalty for Bad Checks and Money Orders**

### **Present Law**

The Code<sup>36</sup> imposes a penalty on a person who tenders a bad check or money orders. The penalty is two percent of the amount of the bad check or money order. For checks or money orders that are less than \$750, the minimum penalty is \$15 (or, if less, the amount of the check or money order).

### **Description of Proposal**

The proposal increases the minimum penalty to \$25 (or, if less, the amount of the check or money order), applicable to checks or money orders that are less than \$1,250.

### **Effective Date**

The proposal is effective with respect to checks or money orders received after the date of enactment.

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<sup>36</sup> Sec. 6657.

## J. Treatment of Contingent Payment Convertible Debt Instruments

### Present Law

Under present law, a taxpayer generally deducts the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. In the case of original issue discount (“OID”), the issuer of a debt instrument generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the OID may not be paid until the maturity of the instrument.

The amount of OID with respect to a debt instrument is equal to the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts that are payable on the debt instrument by maturity. The amount of OID with respect to a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased or decreased by adjustments prior to the accrual period) by the instrument’s yield to maturity, and then subtracting any payments on the debt instrument (other than non-OID stated interest) during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a particular period, the stated redemption price at maturity and the time of maturity must be known. Issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holders of such instruments accrue and include in gross income the amount of OID as interest income.

Treasury regulations provide special rules for determining the amount of OID allocated to a period with respect to certain debt instruments that provide for one or more contingent payments of principal or interest.<sup>37</sup> The regulations provide that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt.<sup>38</sup> The regulations also provide that a payment is not a contingent payment merely because of a contingency that, as of the issue date of the debt instrument, is either remote or incidental.<sup>39</sup>

In the case of contingent payment debt instruments that are issued for money or publicly traded property,<sup>40</sup> the regulations provide that interest on a debt instrument must be taken into account (as OID) whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of OID that is taken into account for each accrual period is determined by constructing a comparable yield and a projected payment schedule for the debt instrument,

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<sup>37</sup> Treas. reg. sec. 1.1275-4.

<sup>38</sup> Treas. reg. sec. 1.1275-4(a)(4).

<sup>39</sup> Treas. reg. sec. 1.1275-4(a)(5).

<sup>40</sup> Treas. reg. sec. 1.1275-4(b).

and then accruing the OID on the basis of the comparable yield and projected payment schedule by applying rules similar to those for accruing OID on a noncontingent debt instrument (the “noncontingent bond method”). If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference. The comparable yield for a debt instrument is the yield at which the issuer would be able to issue a fixed-rate noncontingent debt instrument with terms and conditions similar to those of the contingent payment debt instrument (i.e., the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.<sup>41</sup>

With respect to certain debt instruments that are convertible into the common stock of the issuer and that also provide for contingent payments (other than the conversion feature) -- often referred to as “contingent convertible” debt instruments -- the IRS has stated that the noncontingent bond method applies in computing the accrual of OID on the debt instrument.<sup>42</sup> In applying the noncontingent bond method, the IRS has stated that the comparable yield for a contingent convertible debt instrument is determined by reference to a comparable fixed-rate nonconvertible debt instrument, and the projected payment schedule is determined by treating the issuer stock received upon a conversion of the debt instrument as a contingent payment.

### **Description of Proposal**

The proposal provides that, in the case of a contingent convertible debt instrument,<sup>43</sup> any Treasury regulations which require OID to be determined by reference to the comparable yield of a noncontingent fixed-rate debt instrument shall be applied as requiring that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock. For purposes of applying the proposal, the comparable yield shall be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. Thus, the noncontingent bond method in the Treasury regulations shall be applied in a manner such that the comparable yield for contingent convertible debt instruments shall be determined by reference to comparable noncontingent fixed-rate convertible (rather than nonconvertible) debt instruments.

### **Effective Date**

The proposal is effective for debt instruments issued on or after date of enactment.

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<sup>41</sup> Treas. Reg. sec. 1.1275-4(b)(4)(i)(A).

<sup>42</sup> Rev. Rul. 2002-31, 2002-1 C.B. 1023.

<sup>43</sup> Under the proposal, a contingent convertible debt instrument is defined as a debt instrument that: (1) is convertible into stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation; and (2) provides for contingent payments.

## **K. Extension of IRS User Fees**

### **Present Law**

The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.<sup>44</sup> These user fees are authorized by statute through September 30, 2014.

### **Description of Proposal**

The proposal extends the statutory authorization for user fees for two years, through September 30, 2016.

### **Effective Date**

The proposal is effective for requests made after the date of enactment.

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<sup>44</sup> Section 7528.

## **L. Modification of Collection Due Process Procedures for Employment Tax Liabilities**

### **Present Law**

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property. A Federal tax lien arises automatically when (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial collection due process ("CDP") hearing before levy may be made on any property or right to property.<sup>45</sup> Similar rules apply with respect to notices of tax liens, although the right to a hearing arises only on the filing of a notice.<sup>46</sup> The CDP hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. Under present law, taxpayers are not entitled to a pre-levy CDP hearing if a levy is issued to collect a Federal tax liability from a State tax refund or if collection of the Federal tax is in jeopardy. However, levies related to State tax refunds or jeopardy determinations are subject to post-levy review through the CDP hearing process.

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and the requirement that employers withhold income taxes from wages paid to employees ("income tax withholding").<sup>47</sup> Income tax withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

### **Description of Proposal**

Under the proposal, levies issued to collect Federal employment taxes are excepted from the pre-levy CDP hearing requirement. Thus, under the proposal, taxpayers have no right to a CDP hearing before a levy is issued to collect employment taxes. However, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy. Collection by levy is permitted to continue during the CDP proceedings.

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<sup>45</sup> Sec. 6330(a).

<sup>46</sup> Sec. 6320.

<sup>47</sup> Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). FICA taxes consist of an employer share and an employee share, which the employer withholds from employees' wages.



### **Effective Date**

The proposal is effective for levies issued on or after the date that is 120 days after the date of enactment.

## **M. Whistleblower Reforms**

### **Present Law**

The Code authorizes the IRS to pay such sums as deemed necessary for: “(1) detecting underpayments of tax; and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same.”<sup>48</sup> Generally, amounts are paid based on a percentage of tax, fines, and penalties (but not interest) actually collected based on the information provided.

The Tax Relief and Health Care Act of 2006 (the “Act”)<sup>49</sup> established an enhanced reward program for actions in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed \$2,000,000 and, if the taxpayer is an individual, the individual’s gross income exceeds \$200,000 for any taxable year. The reward floor in such cases is 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS’s attention by an individual. The available reward in such cases is limited to 30 percent of the collected proceeds.

Under present law, the Secretary is required to issue guidance within one year of the date of enactment of the Act for the establishment of the Whistleblower Office within the IRS to administer the reward program. The Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract.

The Act permits an individual to appeal the amount or a denial of an award determination to the United States Tax Court (the “Tax Court”) within 30 days of such determination. Tax Court review of an award determination may be assigned to a special trial judge.

The Act also required the Secretary to conduct a study and report to Congress on the effectiveness of the whistleblower reward program and any legislative or administrative recommendations regarding the administration of the program.

### **Description of Proposal**

The proposal modifies the reward program established under the Act. Under the proposal, this reward program applies to any actions in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed \$20,000 and, if the taxpayer is an individual, the individual’s gross income exceeds \$200,000 for any taxable year.

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<sup>48</sup> Sec. 7623.

<sup>49</sup> Pub. L. No. 109-432.

The proposal also establishes the Whistleblower Office under the Code, rather than pursuant to regulation as provided in the Act. Although recognizing that many functions of the IRS may be involved in evaluating or otherwise addressing an informant's claim, the Congress intends that one office within the IRS ultimately is responsible and accountable for monitoring informant claims for reward and determining the amounts to be rewarded. This will ensure that all claims are considered and that awards are issued in a consistent, timely and equitable manner.

In addition, the proposal requires the Secretary to report to Congress within six months of the date of enactment on the implementation of this proposal, including the operation of the Whistleblower Office and the implementation of the recommendations of the Treasury Inspector General for Tax Administration.<sup>50</sup>

Finally, the proposal authorizes the Tax Court to adopt rules to preserve the anonymity, privacy, or confidentiality of any person appealing the denial of an award determination or any person who is the subject of the enforcement action upon which the award determination is based.

#### **Effective Date**

The proposal is effective for information provided on or after the date of enactment.

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<sup>50</sup> Treasury Inspector General for Tax Administration, *The Informants' Rewards Program Needs More Centralized Management Oversight*, 2006-30-092 (June 2006).

## **N. Modify Definition of Covered Employee for Denial of Deduction for Excessive Employee Remuneration**

### **Present Law**

Under present law, compensation in excess of \$1 million paid by a publicly-held corporation to the corporation's "covered employees" generally is not deductible.<sup>51</sup> Covered employees are the chief executive officer as of the close of the taxable year and the four other most highly compensated officers of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid, whether the compensation is for services as a covered employee, and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken.

Performance-based compensation is not subject to the deduction limitation and is not taken into account in determining whether other compensation exceeds \$1 million. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals and with respect to which certain requirements are satisfied, including a shareholder approval requirement.<sup>52</sup>

### **Description of Proposal**

The proposal modifies the definition of covered employee. Under the proposal, covered employees include any individual who was the Chief Executive Officer of the company at any time during the taxable year. In addition, covered employees include the four officers with the highest compensation for the year. Under the proposal, covered employees also include individuals who previously were covered employees for any preceding taxable year beginning after December 31, 2006, with respect to the corporation (and beneficiaries of such persons). For example, if the Chief Executive Officer retires in November, compensation received in the year of retirement, or paid under a deferral agreement in a succeeding year, is subject to the deduction limitations for a covered employee.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2006.

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<sup>51</sup> Sec. 162(m).

<sup>52</sup> In addition, the following types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds \$1 million: (1) compensation payable on a commission basis; (2) payments to a tax-qualified retirement plan (including salary reduction contributions); and (3) amounts that are excludable from the individual's gross income (such as employer-provided health benefits). Sec. 162(m)(4).