

**DESCRIPTION OF THE CHAIRMAN'S AMENDMENT  
IN THE NATURE OF A SUBSTITUTE OF H.R. 3996,  
THE "TEMPORARY TAX RELIEF ACT OF 2007"**

Scheduled for Markup  
by the  
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Prepared by the Staff  
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## INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of H.R. 3996, the “Temporary Tax Relief Act of 2007.” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman’s amendment in the nature of a substitute of H.R. 3996.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman’s Amendment in the Nature of a Substitute of H.R. 3996, The “Temporary Tax Relief Act of 2007.”* November 1, 2007, (JCX-106-07). This document can also be found on our website at [www.house.gov/jct](http://www.house.gov/jct).

## II. EXTEND ALTERNATIVE MINIMUM TAX RELIEF FOR INDIVIDUALS

### Present Law

Present law imposes an alternative minimum tax on individuals. The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The present exemption amount is: (1) \$62,550 (\$45,000 in taxable years beginning after 2006) in the case of married individuals filing a joint return and surviving spouses; (2) \$42,500 (\$33,750 in taxable years beginning after 2006) in the case of other unmarried individuals; (3) \$31,275 (\$22,500 in taxable years beginning after 2006) in the case of married individuals filing separate returns; and (4) \$22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2007, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2006, the nonrefundable personal credits (other than the adoption credit, child credit and saver's credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and saver's credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.<sup>2</sup>

### Description of Proposal

The proposal provides that the individual AMT exemption amount for taxable years beginning in 2007 is \$66,250, in the case of married individuals filing a joint return and

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<sup>2</sup> The rule applicable to the adoption credit and child credit is subject to the EGTRRA sunset.

surviving spouses; (2) \$44,350 in the case of other unmarried individuals; and (3) \$33,125 in the case of married individuals filing separate returns.

For taxable years beginning in 2007, the proposal allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

**Effective Date**

The proposal is effective for taxable years beginning in 2007.

### **III. ADDITIONAL REDUCTIONS FOR INDIVIDUALS**

#### **1. Additional standard deduction for State and local real property taxes**

##### **Present Law**

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.

##### **Description of Proposal**

The proposal allows taxpayers an additional standard deduction for State and local real property taxes for taxpayers who claim the regular standard deduction. The additional standard deduction applies only for 2008, and is limited to \$350 (\$700 in the case of a married individual filing jointly). The additional standard deduction for real property taxes is not permitted for purposes of determining an individual's alternative minimum tax liability.

##### **Effective Date**

The proposal applies to taxable years beginning in 2008.

#### **2. Refundable child credit**

##### **Present Law**

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is \$1,000 through 2010, and \$500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). The threshold dollar amount is \$11,750 (2007), and is indexed for inflation.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned

income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit ("EIC").

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

### **Description of Proposal**

The proposal modifies the earned income formula for the determination of the refundable child credit to apply to 15 percent of earned income in excess of \$8,500 for taxable years beginning in 2008.

### **Effective Date**

The proposal is effective for taxable years beginning in 2008.

## IV. ONE YEAR EXTENDERS

### A. Extenders Primarily Affecting Individuals

#### 1. Deduction of State and local general sales taxes

##### Present Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004 and 2005, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

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

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

## **Description of Proposal**

The present-law provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes is extended for one year (through December 31, 2008).

## **Effective Date**

The provision applies to taxable years beginning after December 31, 2007.

## **2. Above-the-line deduction for higher education expenses**

### **Present Law**

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.<sup>3</sup> Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.<sup>4</sup> The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2007.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,<sup>5</sup> and by the amount of such expenses taken into account for purposes of determining

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<sup>3</sup> Sec. 222.

<sup>4</sup> The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

<sup>5</sup> Secs. 222(d)(1) and 25A(g)(2).

any exclusion from gross income of: (1) income from certain U.S. Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.<sup>6</sup> Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope credit or Lifetime Learning credit is elected for such taxable year.

### **Description of Proposal**

The proposal extends the qualified tuition deduction for one year.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2007, and prior to January 1, 2009.

## **3. Extension of special withholding tax rule for interest-related dividends paid by regulated investment companies**

### **Present Law**

#### **In general**

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

#### **Interest-related dividends**

Under present law, a RIC may, under certain circumstances, designate all or a portion of a dividend as an “interest-related dividend,” by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. In addition, an interest-related dividend received by a foreign person generally is exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

However, this exemption does not apply to a dividend on shares of RIC stock if the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption does not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury

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<sup>6</sup> Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally does not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend (i.e., the controlled foreign corporation) is a related person. Nor does the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original issue discount or bank deposit interest) received by the RIC on indebtedness issued by the RIC-dividend recipient or by any corporation or partnership with respect to which the recipient of the RIC dividend is a 10-percent shareholder. However, in these two circumstances the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend is treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country exceptions of subpart F (see sec. 881(c)(5)(A)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of: (1) the amount of qualified interest income of the RIC; over (2) the amount of expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

If the amount designated as an interest-related dividend is greater than the qualified net interest income described above, the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

This withholding tax rule for interest-related dividends received from a RIC does not apply to any taxable year of a RIC beginning after December 31, 2007.

### **Description of Proposal**

The proposal extends the exemption from withholding tax of interest-related dividends received from a RIC to taxable years of a RIC beginning before January 1, 2009.

### **Effective Date**

The proposal applies to estates of decedents dying after December 31, 2007.

## **4. Extension of parity in the application of certain limits to mental health benefits**

### **Present Law**

The Code, the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Public Health Service Act (“PHSA”) contain provisions under which group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits (“mental health parity requirements”). In the case of a group health plan which provides benefits for mental health, the mental health parity requirements do not affect the terms and conditions (including cost sharing, limits on numbers of visits or days of coverage, and requirements relating to medical necessity) relating to the amount, duration, or scope of mental health benefits under the plan, except as specifically provided in regard to parity in the imposition of aggregate lifetime limits and annual limits.

The Code imposes an excise tax on group health plans which fail to meet the mental health parity requirements. The excise tax is equal to \$100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer’s group health plan expenses for the prior year or \$500,000. No tax is imposed if the Secretary determines that the employer did not know, and in exercising reasonable diligence would not have known, that the failure existed.

The mental health parity requirements do not apply to group health plans of small employers nor do they apply if their application results in an increase in the cost under a group health plan of at least one percent. Further, the mental health parity requirements do not require group health plans to provide mental health benefits.

The Code, ERISA and PHSA mental health parity requirements are scheduled to expire with respect to benefits for services furnished after December 31, 2007.

### **Description of Proposal**

The proposal extends the present-law Code excise tax for failure to comply with the mental health parity requirements through December 31, 2008.

### **Effective Date**

The proposal is effective for benefits for services furnished after December 31, 2007.

## **5. Extend the special rule encouraging contributions of capital gain real property for conservation purposes**

### **Present Law**

#### **Charitable contributions generally**

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.<sup>7</sup>

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

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

#### **Capital gain property**

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions

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<sup>7</sup> Secs. 170, 2055, and 2522, respectively. Unless otherwise provided, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

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

### **Qualified conservation contributions**

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

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

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

#### **In general**

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005,<sup>8</sup> the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable

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<sup>8</sup> Sec. 170(b)(1)(E).

charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

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

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

#### Farmers and ranchers

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

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

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.<sup>9</sup>

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

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

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<sup>9</sup> Sec. 170(b)(2)(B).

## Termination

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2007.

## Description of Proposal

The proposal extends the special rule regarding contributions of capital gain real property for conservation purposes for contributions made in taxable years beginning before January 1, 2009.

## Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2007.

## **6. Tax-free distributions from individual retirement plans for charitable purposes**

### Present Law

#### In general

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

#### Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans’ organizations, fraternal societies, and cemetery companies,<sup>10</sup> or to a Federal, State, or local governmental entity for exclusively public purposes.<sup>11</sup> The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>12</sup>

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<sup>10</sup> Secs. 170(c)(3)-(5).

<sup>11</sup> Sec. 170(c)(1).

<sup>12</sup> Secs. 170(b) and (e).

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.<sup>13</sup>

A payment to a charity (regardless of whether it is termed a “contribution”) in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.<sup>14</sup> In addition, present law requires that any charity that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.<sup>15</sup>

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

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

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2006 is \$150,500 (\$75,250 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit.

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<sup>13</sup> Sec. 170(a).

<sup>14</sup> Sec. 170(f)(8).

<sup>15</sup> Sec. 6115.

Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.<sup>16</sup> Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.<sup>17</sup> For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

### **IRA rules**

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70-½.<sup>18</sup>

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

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<sup>16</sup> Secs. 170(f), 2055(e)(2), and 2522(c)(2).

<sup>17</sup> Sec. 170(f)(2).

<sup>18</sup> Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;<sup>19</sup> (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.<sup>20</sup> Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

### **Qualified charitable distributions**

Present law provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.<sup>21</sup> The exclusion may not exceed \$100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-1/2.

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

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<sup>19</sup> Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

<sup>20</sup> Sec. 3405.

<sup>21</sup> The exclusion does not apply to distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions (“SEPs”).

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

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

The exclusion for qualified charitable distributions applies to distributions made in taxable years beginning after December 31, 2005. Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2007.

### **Description of Proposal**

The proposal would extend the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2007, and before January 1, 2009.

### **Effective Date**

The proposal is effective for distributions made in taxable years beginning after December 31, 2007.

## **7. Educator expense deduction**

### **Present Law**

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of \$156,400 (for 2007).<sup>22</sup> In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

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<sup>22</sup> The adjusted gross income threshold is \$78,200 in the case of a married individual filing a separate return (for 2007).

Eligible educators are allowed an above-the-line deduction for certain expenses.<sup>23</sup> Specifically, for taxable years beginning after December 31, 2001, and prior to January 1, 2008, an above-the-line deduction is allowed for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2007.

### **Description of Proposal**

The proposal extends the deduction for eligible educator expenses for one year.

### **Effective Date**

The proposal is effective for expenses paid or incurred in taxable years beginning after December 31, 2007, and prior to January 1, 2009.

## **8. One year extension of the election to treat combat pay as earned income for purposes of the earned income credit**

### **Present Law**

#### **In general**

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone may be excluded from gross income. In addition, for up to two years following service in a combat zone, military personnel may also exclude compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in the combat zone.

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<sup>23</sup> Sec. 62(a)(2)(D).

### **Child credit**

Combat pay that is otherwise excluded from gross income under section 112 is treated as earned income which is taken into account in computing taxable income for purposes of calculating the refundable portion of the child credit.<sup>24</sup>

### **Earned income credit**

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending after the date of enactment and before January 1, 2008.

### **Description of Proposal**

The provision extends for one year the availability of the election to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit.

### **Effective Date**

The provision is effective in taxable years beginning after December 31, 2007 and before January 1, 2009.

## **9. Extension of qualified mortgage bond program rules for veterans**

### **Present Law**

Private activity bonds are bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”). The definition of a qualified private activity bond includes both qualified mortgage bonds and qualified veterans’ mortgage bonds.

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement).

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<sup>24</sup> Unless otherwise provided, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

Under a special rule, qualified mortgage bonds may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement. Present-law income and purchase price limitations apply to loans to veterans financed with the proceeds of qualified mortgage bonds. Veterans are eligible for the exception from the first-time homebuyer requirement without regard to the date they last served on active duty or the date they applied for a loan after leaving active duty. However, veterans may only use the exception one time. This provision applies to bonds issued before January 1, 2008.

### **Description of Proposal**

The proposal extends for one year the first-time homebuyer exception for veterans under the qualified mortgage bond program.

### **Effective Date**

The proposal applies to bonds issued after December 31, 2007 and before January 1, 2009.

## **10. Treatment of distributions to individuals called to active duty for at least 180 days**

### **Present Law**

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Certain amounts held in a qualified cash or deferred arrangement (a “section 401(k) plan”) or in a tax-sheltered annuity (a “section 403(b) annuity”) may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee.

Pursuant to amendments to section 72(t) made by the Pension Protection Act of 2006,<sup>25</sup> the 10-percent early withdrawal tax does not apply to a qualified reservist distribution. A qualified reservist distribution is a distribution (1) from an IRA or attributable to elective deferrals under a section 401(k) plan, section 403(b) annuity, or certain similar arrangements, (2) made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the U.S. Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A section 401(k) plan or section 403(b) annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

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<sup>25</sup> Pub. L. No. 109-280.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to this special repayment rule. No deduction is allowed for any contribution made under the special repayment rule.

The special rules applicable to a qualified reservist distribution apply to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007.

### **Description of Proposal**

The proposal extends the rules applicable to qualified reservist distributions to individuals ordered or called to active duty before January 1, 2009.

### **Effective Date**

The proposal is effective upon enactment.

## **11. Extension of special rule for regulated investment company stock held in the estate of a nonresident non-citizen**

### **Present Law**

The gross estate of a decedent who was a U.S. citizen or resident generally includes all property – real, personal, tangible, and intangible – wherever situated.<sup>26</sup> The gross estate of a nonresident non-citizen decedent, by contrast, generally includes only property that at the time of the decedent’s death is situated within the United States.<sup>27</sup> Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments, but does not include either bank deposits or portfolio obligations the interest on which would be exempt from U.S. income tax under section 871.<sup>28</sup> Stock owned and held by a nonresident non-citizen generally is treated as property within the United States if the stock was issued by a domestic corporation.<sup>29</sup>

Treaties may reduce U.S. taxation of transfers of the estates of nonresident non-citizens. Under recent treaties, for example, U.S. tax generally may be eliminated except insofar as the

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<sup>26</sup> Sec. 2031. The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA’s rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

<sup>27</sup> Sec. 2103.

<sup>28</sup> Secs. 2104(c), 2105(b).

<sup>29</sup> Sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Although stock issued by a domestic corporation generally is treated as property within the United States, stock of a regulated investment company (“RIC”) that was owned by a nonresident non-citizen is not deemed property within the United States in the proportion that, at the end of the quarter of the RIC’s taxable year immediately before a decedent’s date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (the “estate tax look-through rule for RIC stock”).<sup>30</sup> This estate tax look-through rule for RIC stock does not apply to estates of decedents dying after December 31, 2007.

### **Description of Proposal**

The proposal permits the estate tax look-through rule for RIC stock to apply to estates of decedents dying before January 1, 2009.

### **Effective Date**

The proposal applies to estates of decedents dying after December 31, 2007.

## **12. Extend RIC “qualified investment entity” treatment under FIRPTA**

### **Present law**

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

A USPRI, the sale of which is subject to FIRPTA tax, includes stock or a beneficial interest in any U.S. real property holding corporation (as defined), unless the stock is regularly traded on an established securities market and the selling foreign corporation or nonresident alien individual held no more than 5 percent of that stock within the 5-year period ending on date of disposition (or, if shorter, during the period in which the entity was in existence). There is an exception, however, for stock of a domestically controlled “qualified investment entity.” However, if stock of a domestically controlled qualified investment entity is disposed of within the 30 days preceding a dividend distribution in an “applicable wash sale transaction,” in which an amount that would have been a taxable distribution (as described below) is instead treated as nontaxable sales proceeds, but substantially similar stock is reacquired (or an option to obtain it

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<sup>30</sup> Sec. 2105(d).

is acquired) within a 61 day period, then the amount that would have been a taxable distribution continues to be taxed.

A distribution from a “qualified investment entity” that is attributable to the sale of a USRPI is subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United States and the recipient foreign corporation or nonresident alien individual held no more than 5 percent of that class of stock or beneficial interest within the 1-year period ending on the date of distribution. Special rules apply to situations involving tiers of qualified investment entities.

The term “qualified investment entity” includes a regulated investment company (“RIC”) that meets certain requirements, although the inclusion of a RIC in that definition is scheduled to expire, for certain purposes, on December 31, 2007.<sup>31</sup> The definition does not expire for purposes of taxing distributions from the RIC that are attributable directly or indirectly to a distribution to the entity from a real estate investment trust, nor for purposes of the applicable wash sale rules.

### **Description of Proposal**

The proposal would extend the inclusion of a regulated investment company (RIC) within the definition of a “qualified investment entity” under section 897 of the Code through December 31, 2008, for those situations in which that that inclusion would otherwise expire at the end of 2007.

### **Effective Date**

The proposal would take effect on January 1, 2008.

## **13. State legislators’ travel expenses away from home**

### **Present Law**

In general, for Federal income tax purposes, any individual who is a State legislator, at any time during the year, may elect to deduct deemed living expenses while away from home as a miscellaneous itemized deduction.<sup>32</sup> A State legislator’s place of residence, or tax home, shall be considered the legislative district represented. A State legislator is deemed to incur for living expenses an amount equal to the product of the State’s legislative days and the per diem amount.

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<sup>31</sup> Section 897(h)

<sup>32</sup> Sec. 162(h).

The State's legislative days is the number of days the legislature was in session (including any day not in session for a period of four consecutive days or less),<sup>33</sup> plus any day the physical presence of the individual was recorded at a committee meeting.<sup>34</sup>

The per diem amount is the greater of: (1) the per diem amount allowable to employees of the State, for which he or she is a legislator, while away from home, not to exceed 110 percent of the Federal government amount,<sup>35</sup> or (2) the amount allowable to employees of the Federal government for per diem while away from home.<sup>36</sup>

However, the exception does not apply if the legislative district is within 50 miles of the State Capitol.<sup>37</sup>

### **Description of Proposal**

The proposal modifies the definition of legislative days to include any day in which the legislature is formally called into session without regard to whether legislation was considered on such day. These days are commonly referred to as a "pro forma" legislative session. The proposal applies to legislative days before January 1, 2009.

### **Effective Date**

The proposal is effective for expenses incurred after December 31, 2007.

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<sup>33</sup> Sec. 162(h)(2)(A).

<sup>34</sup> Sec. 162(h)(2)(B).

<sup>35</sup> Sec. 162(h)(1)(B)(i).

<sup>36</sup> Sec. 162(h)(1)(B)(ii).

<sup>37</sup> Sec. 162(h)(4).

## **B. Extenders Primarily Affecting Businesses**

### **1. Extend the research and experimentation tax credit**

#### **Present Law**

##### **General rule**

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.<sup>38</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.<sup>39</sup>

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

The research credit, including the university basic research credit and the energy research credit, is scheduled to expire and generally will not apply to amounts paid or incurred after December 31, 2007.<sup>40</sup>

##### **Computation of allowable credit**

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

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<sup>38</sup> Sec. 41.

<sup>39</sup> Sec. 41(e).

<sup>40</sup> The research tax credit was initially enacted in the Economic Recovery Tax Act of 1981. It has been subsequently extended and modified numerous times. Most recently, the Tax Relief and Health Care Act of 2006 extended the research credit through December 31, 2007, modified the alternative incremental research credit, and added an election to claim an alternative simplified credit.

least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.<sup>41</sup>

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.<sup>42</sup> Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.<sup>43</sup>

### **Alternative incremental research credit regime**

Taxpayers are allowed to elect an alternative incremental research credit regime.<sup>44</sup> If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base

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

<sup>42</sup> Sec. 41(f)(1).

<sup>43</sup> Sec. 41(f)(3).

<sup>44</sup> Sec. 41(c)(4).

percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above are increased to three percent, four percent, and five percent, respectively.<sup>45</sup>

An election to be subject to this alternative incremental credit regime can be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

### **Alternative simplified credit**

Generally, for amounts paid or incurred after 2006, taxpayers may elect to claim an alternative simplified credit for qualified research expenses.<sup>46</sup> The alternative simplified research credit is equal to 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes January 1, 2007. The transition rule applies only to the taxable year which includes that date.

### **Eligible expenses**

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).<sup>47</sup> Notwithstanding the limitation for

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<sup>45</sup> A special transition rule applies for fiscal year 2006-2007 taxpayers.

<sup>46</sup> A special transition rule applies for fiscal year 2006-2007 taxpayers.

<sup>47</sup> Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research,

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

To be eligible for the credit, the research does not only have to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.<sup>48</sup> In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.<sup>49</sup> Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

### **Relation to deduction**

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.<sup>50</sup> However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.<sup>51</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.<sup>52</sup>

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and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

<sup>48</sup> Sec. 41(d)(3).

<sup>49</sup> Sec. 41(d)(4).

<sup>50</sup> Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

<sup>51</sup> Sec. 280C(c).

<sup>52</sup> Sec. 280C(c)(3).

## **Description of Proposal**

The proposal extends the research credit for one year.

## **Effective Date**

The proposal is effective for amounts paid or incurred after December 31, 2007.

## **2. Indian employment tax credit**

### **Present Law**

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees (sec. 45A). The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

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

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of \$30,000 (which after adjustment for inflation is currently \$40,000).<sup>53</sup> In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a 5 percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

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<sup>53</sup> See Form 8845, Indian Employment Credit (Rev. December 2006).

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before January 1, 2007.

### **Description of Proposal**

The proposal extends for one year the present-law employment credit provision (through taxable years beginning on or before December 31, 2008).

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2007.

## **3. Extend the new markets tax credit**

### **Present Law**

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (“CDE”).<sup>54</sup> The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

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

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<sup>54</sup> Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (December 21, 2000).

qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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

The Secretary has the authority to designate “targeted populations” as low-income communities for purposes of the new markets tax credit. For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, “low-income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.<sup>55</sup> Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

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

The maximum annual amount of qualified equity investments is capped at \$2.0 billion per year for calendar years 2004 and 2005, and at \$3.5 billion per year for calendar years 2006, 2007, and 2008.

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<sup>55</sup> 12 U.S.C. 4702(17) (defines “low-income” for purposes of 12 U.S.C. 4702(20)).

## Description of Proposal

The provision extends the new markets tax credit for one year, through 2009, permitting up to \$3.5 billion in qualified equity investments for that calendar year.

### Effective Date

The provision is effective on the date of enactment.

## **4. Extend railroad track maintenance credit**

### Present Law

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during the taxable year.<sup>56</sup> The credit is limited to the product of \$3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.<sup>57</sup> Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. Under the provision, the credit is limited in respect of the total number of miles of track (1) owned or leased by the Class II or Class III railroad and (2) assigned to the Class II or Class III railroad for purposes of the credit.

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).<sup>58</sup>

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.<sup>59</sup>

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.<sup>60</sup>

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<sup>56</sup> Sec. 45G(a).

<sup>57</sup> Sec. 45G(b)(1).

<sup>58</sup> Sec. 45G(d).

<sup>59</sup> Sec. 45G(c).

<sup>60</sup> Sec. 45G(e)(1).

The provision applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning after December 31, 2004, and before January 1, 2008.

### **Description of Proposal**

The proposal extends the present law provision for one year, for qualified railroad track maintenance expenditures paid or incurred before January 1, 2009.

### **Effective Date**

The proposal is effective for expenditures paid or incurred after December 31, 2007.

## **5. Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant improvements**

### **Present Law**

#### **In general**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>61</sup> The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

#### **Depreciation of leasehold improvements**

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

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<sup>61</sup> Sec. 168.

### **Qualified leasehold improvement property**

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2008. Qualified leasehold improvement property is recovered using the straight-line method. Leasehold improvements placed in service in 2008 and later will be subject to the general rules described above.

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

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

### **Qualified restaurant property**

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2008. For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method.

### **Description of Proposal**

The present-law provisions for qualified leasehold improvement property and qualified restaurant property are extended for one year (through December 31, 2008).

### **Effective Date**

The proposal applies to property placed in service after December 31, 2007.

## **6. 7-year recovery period for motorsports racetrack property**

### **Present Law**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system

(“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>62</sup> The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years. Additionally, a motorsports entertainment complex placed in service before December 31, 2007 is assigned a recovery period of seven years.<sup>63</sup> For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land that during the 36 month period following its placed in service date it hosts a racing event.<sup>64</sup> The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands).

### **Description of Proposal**

The proposal extends the present law seven year recovery period for one year through December 31, 2008.

### **Effective Date**

The proposal is effective for property placed in service after December 31, 2007.

## **7. Accelerated depreciation for business property on Indian reservations**

### **Present Law**

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

3-year property	2 years
5-year property	3 years
7-year property	4 years

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<sup>62</sup> Sec. 168.

<sup>63</sup> Sec. 168(e)(3)(C)(ii).

<sup>64</sup> Sec. 168(i)(15).

10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

“Qualified Indian reservation property” eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;<sup>65</sup> and (4) is not property placed in service for purposes of conducting gaming activities.<sup>66</sup> Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).<sup>67</sup>

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974 or section 4(10) of the Indian Child Welfare Act of 1978. For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2008.

### **Description of Proposal**

The proposal extends for one year the present-law incentive relating to depreciation of qualified Indian reservation property (to apply to property placed in service through December 31, 2008).

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<sup>65</sup> For these purposes, related persons is defined in Sec. 465(b)(3)(C).

<sup>66</sup> Sec. 168(j)(4)(A).

<sup>67</sup> Sec. 168(j)(4)(C).

## Effective Date

The proposal applies to property placed in service after December 31, 2007.

### **8. Extend expensing of brownfields remediation costs**

#### Present Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.<sup>68</sup> Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define “capital expenditures” as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Taxpayers may elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred.<sup>69</sup> The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*<sup>70</sup> and section 263A, are treated as qualified environmental remediation expenditures.

A “qualified contaminated site” (a so-called “brownfield”) generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”)<sup>71</sup> cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to

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<sup>68</sup> Sec. 162.

<sup>69</sup> Sec. 198.

<sup>70</sup> 418 U.S. 1 (1974).

<sup>71</sup> Pub. L. No. 96-510 (1980).

asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3) of the Code.

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

Eligible expenditures are those paid or incurred before January 1, 2008.

The Gulf Opportunity Zone Act of 2005<sup>72</sup> added section 1400N(g) to the Code, which extended for two years (through December 31, 2007) the expensing of environmental remediation expenditures paid or incurred to abate contamination at qualified contaminated sites located in the Gulf Opportunity Zone. As a result of the extension of section 198 contained in the Tax Relief and Health Care Act of 2006,<sup>73</sup> eligible expenditures covered under both section 1400N(g) and section 198 must be paid or incurred prior to January 1, 2008.

### **Description of Proposal**

The proposal extends the present law expensing provision under section 198 for one year through December 31, 2008.

### **Effective Date**

The proposal is effective for expenditures paid or incurred after December 31, 2007.

## **9. Extension of deduction for income attributable to domestic production activities in Puerto Rico**

### **Present Law**

#### **In general**

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of that income. For taxable years beginning in 2005 and 2006, the deduction is three percent of qualified production activities income and for taxable years beginning in 2007, 2008, and 2009, the

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<sup>72</sup> Pub. L. No. 109-135 (2005).

<sup>73</sup> Pub. L. No. 109-432 (2006).

deduction is six percent of qualified production activities income. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

### **Qualified production activities income**

In general, qualified production activities income is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

### **Domestic production gross receipts**

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property<sup>74</sup> that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film<sup>75</sup> produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

### **Wage limitation**

For taxable years beginning after May 17, 2006, the amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.<sup>76</sup>

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<sup>74</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

<sup>75</sup> Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

<sup>76</sup> For purposes of the provision, “wages” include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer’s taxable year. For taxable years beginning before May 18, 2006, the limitation is based upon all wages paid by the taxpayer, rather than only wages properly allocable to domestic production gross receipts.

Wages paid to bona fide residents of Puerto Rico generally are not included in the wage limitation amount.<sup>77</sup>

### **Rules for Puerto Rico**

When used in the Code in a geographical sense, the term “United States” generally includes only the States and the District of Columbia.<sup>78</sup> A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term “United States” includes the Commonwealth of Puerto Rico, but only if all of the taxpayer’s gross receipts are taxable under the Federal income tax for individuals or corporations.<sup>79</sup> In computing the 50-percent wage limitation, that taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.<sup>80</sup>

The special rules for Puerto Rico apply only with respect to the first two taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2008.

### **Description of Proposal**

The proposal allows the special rules for Puerto Rico to apply for one additional taxable year of a taxpayer.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2007.

## **10. Modify tax treatment of certain payments to controlling exempt organizations**

### **Present Law**

In general, organizations exempt from Federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions.<sup>81</sup> In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.<sup>82</sup>

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<sup>77</sup> Sec. 3401(a)(8)(C).

<sup>78</sup> Sec. 7701(a)(9).

<sup>79</sup> Sec. 199(d)(8)(A).

<sup>80</sup> Sec. 199(d)(8)(B).

<sup>81</sup> Sec. 511.

<sup>82</sup> Sec. 512(b).

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. In general, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). However, a special rule enacted as part of the Pension Protection Act of 2006 provides that, for payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of section 512(b)(13) applies only to the portion of payments received or accrued (before January 1, 2008) in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (i.e., at arm's length).<sup>83</sup> In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

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

### **Description of Proposal**

The proposal extends the special rule of the Pension Protection Act to payments received or accrued before January 1, 2009. Accordingly, under the proposal, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of section 482 (i.e., at arm's length). Any such excess is subject to a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

### **Effective Date**

The proposal is effective for payments received or accrued after December 31, 2007.

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<sup>83</sup> Sec. 512(b)(13)(E).

## **11. Extend and modify qualified zone academy bonds**

### **Present Law**

#### **Tax-exempt bonds**

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools.<sup>84</sup> An issuer must file with the IRS certain information about the bonds issued by them in order for that bond issue to be tax-exempt.<sup>85</sup> Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for State and local bonds does not apply to any arbitrage bond.<sup>86</sup> An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.<sup>87</sup> In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

#### **Qualified zone academy bonds**

As an alternative to traditional tax-exempt bonds, States and local governments were given the authority to issue “qualified zone academy bonds”.<sup>88</sup> A total of \$400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2007. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the

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<sup>84</sup> Sec. 103.

<sup>85</sup> Sec. 149(e).

<sup>86</sup> Sec. 103(a) and (b)(2).

<sup>87</sup> Sec. 148.

<sup>88</sup> Sec. 1397E.

bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond was 50 percent of the face value of the bond.

“Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

The Tax Relief and Health Care Act of 2006 (“TRHCA”)<sup>89</sup> imposed the arbitrage requirements that generally apply to interest-bearing tax-exempt bonds to qualified zone academy bonds. In addition, an issuer of qualified zone academy bonds must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified zone academy property within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified zone academy property during the five-year spending period, bonds will continue to qualify as qualified zone academy bonds if unspent proceeds are used within 90 days from the end of such five-year period to redeem any nonqualified bonds. The five-year spending period may be extended by the Secretary if the issuer establishes that the failure to meet the spending requirement is due to reasonable cause and the related purposes for issuing the bonds will continue to proceed with due diligence. Issuers of qualified zone academy bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

### **Description of Proposal**

The proposal authorizes issuance of up to \$400 million of qualified zone academy bonds annually through 2008.

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<sup>89</sup> Pub. L. 109-432.

The proposal also modifies the spending and arbitrage rules that apply to qualified zone academy bonds. The proposal modifies the spending rule by requiring 95 percent of available project proceeds to be spent on qualified zone academy property. In addition, the proposal modifies the arbitrage rules by providing that available project proceeds invested during the five-year period beginning on the date of issue are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). The proposal defines “available project proceeds” as proceeds from the sale of an issue of qualified zone academy bonds, less issuance costs (not to exceed two percent) and any investment earnings on such proceeds. Thus, available project proceeds invested during the five-year spending period may be invested at unrestricted yields, but the earnings on such investments must be spent on qualified zone academy property.

The proposal also provides that amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner such that the fund will not exceed the amount necessary to repay the issue if invested at the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified zone academy bonds are issued; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified zone academy bonds are issued.

### **Effective Date**

The proposal to extend authority to issue qualified zone academy bonds through 2008 applies to bonds issued after December 31, 2007. The proposal to modify the spending and arbitrage rules applies to bonds issued after the date of enactment.

## **12. Tax incentives for investment in the District of Columbia**

### **Present Law**

#### **In general**

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the “D.C. Zone”), within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Zone designation remains in effect for the period from January 1, 1998, through December 31, 2007. In general, the tax incentives available in connection with the D.C. Zone are a 20-percent wage credit, an additional \$35,000 of section 179 expensing for qualified zone property, expanded tax-exempt financing for certain zone facilities, and a zero-percent capital gains rate from the sale of certain qualified D.C. zone assets.

## **Wage credit**

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

Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only the first \$15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the D.C. Zone may claim the wage credit, regardless of whether the employer meets the definition of a “D.C. Zone business.”<sup>90</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>91</sup> Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer’s work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.<sup>92</sup> In addition, the \$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.<sup>93</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>94</sup>

## **Section 179 expensing**

In general, a D.C. Zone business is allowed an additional \$35,000 of section 179 expensing for qualifying property placed in service by a D.C. Zone business.<sup>95</sup> The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds \$200,000 (\$500,000 for taxable years beginning after 2006 and before 2011). The term “qualified zone property” is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect,

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<sup>90</sup> However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

<sup>91</sup> Sec. 280C(a).

<sup>92</sup> Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

<sup>93</sup> Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

<sup>94</sup> Sec. 38(c)(2).

<sup>95</sup> Sec. 1397A.

(2) the original use of the property in the D.C. Zone commences with the taxpayer, and (3) substantially all of the use of the property is in the D.C. Zone in the active conduct of a trade or business by the taxpayer.<sup>96</sup> Special rules are provided in the case of property that is substantially renovated by the taxpayer.

### **Tax-exempt financing**

A qualified D.C. Zone business is permitted to borrow proceeds from tax-exempt qualified enterprise zone facility bonds (as defined in section 1394) issued by the District of Columbia.<sup>97</sup> Such bonds are subject to the District of Columbia's annual private activity bond volume limitation. Generally, qualified enterprise zone facility bonds for the District of Columbia are bonds 95 percent or more of the net proceeds of which are used to finance certain facilities within the D.C. Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed \$15 million and may be issued only while the D.C. Zone designation is in effect.

### **Zero-percent capital gains**

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years.<sup>98</sup> In general, a qualified "D.C. Zone asset" means stock or partnership interests held in, or tangible property held by, a D.C. Zone business. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent.

In general, gain eligible for the zero-percent tax rate means gain from the sale or exchange of a qualified D.C. Zone asset that is (1) a capital asset or property used in the trade or business as defined in section 1231(b), and (2) acquired before January 1, 2008. Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified D.C. Zone business.<sup>99</sup> However, no gain attributable to periods before January 1, 1998, and after December 31, 2012, is qualified capital gain.

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<sup>96</sup> Sec. 1397D.

<sup>97</sup> Sec. 1400A.

<sup>98</sup> Sec. 1400B.

<sup>99</sup> However, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (i.e., the integrally related test does not apply).

## **District of Columbia homebuyer tax credit**

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to \$5,000 of the amount of the purchase price. The \$5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of \$2,500 each. The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000-\$130,000 for joint filers). For purposes of eligibility, “first-time homebuyer” means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit expires for purchases after December 31, 2007.<sup>100</sup>

### **Description of Proposal**

The proposal extends the designation of the D.C. Zone for one year (through December 31, 2008), thus extending the wage credit and section 179 expensing for one year.

The proposal extends the tax-exempt financing authority for one year, applying to bonds issued during the period beginning on January 1, 1998, and ending on December 31, 2008.

The proposal extends the zero-percent capital gains rate applicable to capital gains from the sale of certain qualified D.C. Zone assets for one year.

The proposal extends the first-time homebuyer credit for one year, through December 31, 2008.

### **Effective Date**

The proposal is effective for periods beginning after, bonds issued after, acquisitions after, and property purchased after December 31, 2007.

## **13. Extension of economic development credit for American Samoa**

### **Present and Prior Law**

#### **In general**

For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit.<sup>101</sup> This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions.<sup>102</sup> For purposes of the credit, possessions included, among other places, American

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<sup>100</sup> Sec. 1400C(i).

<sup>101</sup> Secs. 27(b), 936.

<sup>102</sup> Domestic corporations with activities in Puerto Rico are eligible for the section 30A economic activity credit. That credit is calculated under the rules set forth in section 936.

Samoa. Subject to certain limitations described below, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment.<sup>103</sup> No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under section 936.<sup>104</sup> The section 936 credit generally expired for taxable years beginning after December 31, 2005, but a special credit, described below, was allowed with respect to American Samoa.

To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

The possession tax credit was available only to a corporation that qualified as an existing credit claimant. The determination of whether a corporation was an existing credit claimant was made separately for each possession. The possession tax credit was computed separately for each possession with respect to which the corporation was an existing credit claimant, and the credit was subject to either an economic activity-based limitation or an income-based limitation.

### **Qualification as existing credit claimant**

A corporation was an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit in an election in effect for its taxable year that included October 13, 1995.<sup>105</sup> A corporation that added a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

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<sup>103</sup> Under phase-out rules described below, investment only in Guam, American Samoa, and the Northern Mariana Islands (and not in other possessions) now may give rise to income eligible for the section 936 credit.

<sup>104</sup> Sec. 936(c).

<sup>105</sup> A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a possession on October 13, 1995, and (2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

### **Economic activity-based limit**

Under the economic activity-based limit, the amount of the credit determined under the rules described above was not permitted to exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes.

### **Income-based limit**

As an alternative to the economic activity-based limit, a taxpayer was permitted elect to apply a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income; in taxable years beginning in 1998 and subsequent years, the applicable percentage was 40 percent.

### **Repeal and phase out**

In 1996, the section 936 credit was repealed for new claimants for taxable years beginning after 1995 and was phased out for existing credit claimants over a period including taxable years beginning before 2006. The amount of the available credit during the phase-out period generally was reduced by special limitation rules. These phase-out period limitation rules did not apply to the credit available to existing credit claimants for income from activities in Guam, American Samoa, and the Northern Mariana Islands. As described previously, the section 936 credit generally was repealed for all possessions, including Guam, American Samoa, and the Northern Mariana Islands, for all taxable years beginning after 2005, but a modified credit was allowed for activities in American Samoa.

### **American Samoa economic development credit**

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006 is allowed a credit based on the economic activity-based limitation rules described above. The credit is not part of the Code but is computed based on the rules secs. 30A and 936. The credit is allowed for the first two taxable years of a corporation that first two taxable years of a corporation that begin after December 31, 2005, and before January 1, 2008.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation (described previously) with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the

corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under section 936 does not apply with respect to the credit allowed by the provision.

The credit is not available for taxable years beginning after December 31, 2007.

### **Description of Proposal**

The proposal allows the American Samoa economic development credit for one additional taxable year of a taxpayer.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2007.

## **14. Extend the enhanced charitable deduction for contributions of food inventory**

### **Present Law**

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

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

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.<sup>106</sup> In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.<sup>107</sup> To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

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<sup>106</sup> Sec. 170(e)(3).

<sup>107</sup> Sec. 170(b)(2).

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.<sup>108</sup> Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.<sup>109</sup>

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

Under a temporary provision enacted as part of the Katrina Emergency Tax Relief Act of 2005 and extended by the Pension Protection Act of 2006, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory.<sup>110</sup> For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.<sup>111</sup>

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<sup>108</sup> Treas. Reg. sec. 1.170A-4A(c)(3).

<sup>109</sup> *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

<sup>110</sup> Sec. 170(e)(3)(C).

<sup>111</sup> The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a

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

The temporary provision does not apply to contributions made after December 31, 2007.

### **Description of Proposal**

The proposal extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2009.

### **Effective Date**

The proposal is effective for contributions made after December 31, 2007.

## **15. Extend the enhanced deduction for charitable contributions of book inventory**

### **Present Law**

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

In general, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item’s appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.<sup>112</sup> In general, a C corporation’s charitable contribution deductions for a year may not exceed 10 percent of the corporation’s taxable income.<sup>113</sup> To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee’s exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee’s use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

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C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

<sup>112</sup> Sec. 170(e)(3).

<sup>113</sup> Sec. 170(b)(2).

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.<sup>114</sup> Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

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

The Katrina Emergency Tax Relief Act of 2005 expanded the generally applicable enhanced deduction for C corporations to certain qualified book contributions made after August 28, 2005, and before January 1, 2006. The Pension Protection Act of 2006 extended such deduction for qualified book contributions to contributions made before January 1, 2008. A qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction for qualified book contributions is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs. The donee also must make the certifications required for the generally applicable enhanced deduction, i.e., the donee will (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

#### **Description of Proposal**

The proposal extends the enhanced deduction for contributions of book inventory to contributions made before January 1, 2009.

#### **Effective Date**

The proposal is effective for contributions made after December 31, 2007.

### **16. Extend the enhanced charitable deduction for computer technology and equipment**

#### **Present Law**

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the

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<sup>114</sup> Treas. Reg. sec. 1.170A-4A(c)(3).

taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.<sup>115</sup>

Under present law, a taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified computer contribution."<sup>116</sup> This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2007.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed or assembled the property, not later than the date construction or assembly of the property is substantially completed.<sup>117</sup> The original use of the property must be by the donor or the donee,<sup>118</sup> and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed or assembled by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.<sup>119</sup>

### **Description of Proposal**

The proposal extends the enhanced deduction for computer technology and equipment for one year to apply to contributions made during any taxable year beginning after December 31, 2007, and before January 1, 2009.

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<sup>115</sup> Sec. 170(e)(1).

<sup>116</sup> Secs. 170(e)(4) and 170(e)(6).

<sup>117</sup> If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

<sup>118</sup> This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

<sup>119</sup> Sec. 170(e)(6)(C).

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2007.

## **17. Basis adjustment to stock of S corporation contributing property**

### **Present Law**

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.<sup>120</sup> A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.<sup>121</sup>

In the case of contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2008, the reduction in basis is the fair market value of the contributed property.

### **Description of Proposal**

The proposal extends the rule relating to the basis reduction on account of charitable contributions of property for one year to contributions made in taxable years beginning before January 1, 2009.

The proposal also makes a technical correction to the present-law rule limiting the amount of losses and deductions which a shareholder of an S corporation may take into account in any taxable year to the shareholder's adjusted basis in his stock and indebtedness of the corporation. The technical correction provides that this limitation does not apply to a contribution of appreciated property to the extent the shareholder's pro rata share of the contribution exceeds the shareholder's pro rata share of the adjusted basis of the property.

### **Effective Date**

The proposal extending the basis reduction rule applies to contributions made in taxable years beginning after December 31, 2007.

The technical correction is effective as if included in the legislation enacting the basis reduction rule which is being extended by the proposal.

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<sup>120</sup> Sec. 1366(a)(1)(A).

<sup>121</sup> Sec. 1367(a)(2)(B).

## **18. Extension of the Hurricane Katrina work opportunity tax credit**

### **Present Law**

#### **Work opportunity tax credit**

##### **In general**

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

##### **Targeted groups eligible for the credit**

Generally an employer is eligible for the credit only for qualified wages paid to members of a targeted group. There are nine targeted groups: (1) families receiving Temporary Assistance for Needy Families Program (“TANF”); (2) qualified veterans; (3) qualified ex-felons; (4) designated community residents; (5) vocational rehabilitation referrals; (6) qualified summer youth employees; (7) qualified food stamp recipients; (8) qualified supplemental security income (“SSI”) benefit recipients; and (9) qualified long-term family assistance recipients.

##### **Qualified wages**

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer’s deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally, wages are defined by reference to the FUTA definition of wages contained in sec. 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

##### **Calculation of the credit**

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). There are two exceptions to this general rule. First, with respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). Second, with respect to qualified veterans who are entitled to compensation for a service-connected disability, the maximum credit is \$4,800

because qualified first-year wages are \$12,000 rather than \$6,000 for such individuals.<sup>122</sup> Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of \$10,000 for qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$9,000 (40 percent of the first \$10,000 of qualified first-year wages plus 50 percent of the first \$10,000 of qualified second-year wages).

#### Certification rules

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

#### Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

#### Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

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<sup>122</sup> The expanded definition of qualified first-year wages does not apply to the veterans qualified with reference to a food stamp program, as defined under present law.

### Expiration

The work opportunity tax credit is not available for individuals who begin work for an employer after August 31, 2011.

## **Work Opportunity Tax Credit for Hurricane Katrina Employees**

### In general

The Katrina Emergency Tax Relief Act of 2005 provided that a Hurricane Katrina employee is treated as a member of a targeted group for purposes of the work opportunity tax credit. A Hurricane Katrina employee was: (1) an individual who on August 28, 2005, had a principal place of abode in the core disaster area and was hired during the two-year period beginning on such date for a position, the principal place of employment of which was located in the core disaster area; and (2) an individual who on August 28, 2005, had a principal place of abode in the core disaster area, who was displaced from such abode by reason of Hurricane Katrina and was hired during the period beginning on such date and ending on December 31, 2005 without regard to whether the new principal place of employment is in the core disaster area.

The present-law WOTC certification requirement was waived for such individuals. In lieu of the certification requirement, an individual may have provided to the employer reasonable evidence that the individual is a Hurricane Katrina employee.

The present-law rule that denies the credit with respect to wages of employees who had been previously employed by the employer was waived for the first hire of such employee as a Hurricane Katrina employee unless such employee was an employee of the employer on August 28, 2005.

### Definitions

The term “Hurricane Katrina disaster area” means an area with respect to which a major disaster has been declared by the President before September 14, 2005 under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

The term “core disaster area” means that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

## **Description of Proposal**

The proposal extends through August 28, 2008, the work opportunity tax credit for certain Hurricane Katrina employees employed within the core disaster area. For this purpose, a Hurricane Katrina employee employed within the core disaster area is an individual who on August 28, 2005, had a principal place of abode in the core disaster area and is hired on or after August 28, 2005 and before August 29, 2008 for a position, the principal place of employment of

which was located in the core disaster area.<sup>123</sup> The other special rules (e.g., certification and previous employment) for Hurricane Katrina employees apply.

**Effective Date**

The proposal is effective for individuals hired after August 28, 2007.

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<sup>123</sup> The prior-law work opportunity tax credit for Katrina employees hired to a new place of employment outside of the core disaster area is not extended by this proposal.

## **C. Other Extenders**

### **1. Disclosure of tax information to facilitate combined employment tax reporting**

#### **Present Law**

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual States. This necessitates duplication of items common to both returns. The Code permits the IRS to disclose taxpayer identity information and signatures to any agency, body, or commission of any State for the purpose of carrying out with such agency, body or commission a combined Federal and State employment tax reporting program approved by the Secretary. The Federal disclosure restrictions, safeguard requirements, and criminal penalties for unauthorized disclosure and unauthorized inspection do not apply with respect to disclosures or inspections made pursuant to this authority.

The authority for this program expires December 31, 2007.

Under section 6103(c), the IRS may disclose a taxpayer's return or return information to such person or persons as the taxpayer may designate in a request for or consent to such disclosure. Pursuant to Treasury regulations, a taxpayer's participation in a combined return filing program between the IRS and a State agency, body or commission constitutes a consent to the disclosure by the IRS to the State agency of taxpayer identity information, signature and items of common data contained on the return. No disclosures may be made under this authority unless there are provisions of State law protecting the confidentiality of such items of common data.

#### **Description of Proposal**

The proposal extends for one year (through December 31, 2008) the authority for the combined employment tax reporting program.

#### **Effective Date**

The proposal applies to disclosures after December 31, 2007.

### **2. Disclosure of tax return information relating to terrorist activity**

#### **Present Law**

##### **In general**

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

### Disclosure provisions relating to emergency circumstances

The IRS is authorized to disclose return information to apprise Federal law enforcement agencies of danger of death or physical injury to an individual or to apprise Federal law enforcement agencies of imminent flight of an individual from Federal prosecution.<sup>124</sup> This authority has been used in connection with the investigation of terrorist activity.<sup>125</sup>

### Disclosure provisions relating specifically to terrorist activity

Also among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term “terrorist incident, threat, or activity” is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism.<sup>126</sup>

The term “international terrorism” means activities that involve violent acts or acts dangerous to human life that are a violation of the criminal laws of the United States or of any State, or that would be a criminal violation if committed within the jurisdiction of the United States or of any State; appear to be intended to intimidate or coerce a civilian population, to influence the policy of a government by intimidation or coercion, or to affect the conduct of a government by mass destruction, assassination, or kidnapping; and occur primarily outside the territorial jurisdiction of the United States, or transcend national boundaries in terms of the means by which they are accomplished, the persons they appear intended to intimidate or coerce, or the locale in which their perpetrators operate or seek asylum. The term “domestic terrorism” means activities that involve acts dangerous to human life that are a violation of the criminal laws of the United States or of any State; appear to be intended to intimidate or coerce a civilian population, to influence the policy of a government by intimidation or coercion or to affect the conduct of a government by mass destruction, assassination, or kidnapping; and occur primarily within the territorial jurisdiction of the United States.

In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate Federal law enforcement agency.

No disclosures may be made under these provisions after December 31, 2007. The procedures applicable to these provisions are described in detail below.

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<sup>124</sup> Sec. 6103(i)(3)(B).

<sup>125</sup> See, Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2002 (JCX 29-04)* April 6, 2004.

<sup>126</sup> Sec. 6103(b)(11). For this purpose, “domestic terrorism” is defined in 18 U.S.C. sec. 2331(5) and “international terrorism” is defined in 18 U.S.C. sec. 2331(1).

## **Disclosure of returns and return information - by ex parte court order**

### **Ex parte court orders sought by Federal law enforcement and Federal intelligence agencies**

The Code permits, pursuant to an ex parte court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the ex parte court order to be submitted to a Federal district court judge or magistrate. The Federal district court judge or magistrate would grant the order if based on the facts submitted he or she determines that: (1) there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and (2) the return or return information is sought exclusively for the use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

### **Special rule for ex parte court ordered disclosure initiated by the IRS**

If the Secretary of the Treasury (or his delegate) possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary may, on his own initiative, authorize an application for an ex parte court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. The information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS ex parte court order.

## **Disclosure of return information other than by ex parte court order**

### **Disclosure by the IRS without a request**

The Code permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the

head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. The IRS on its own initiative and without a written request may make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

#### Disclosure upon written request of a Federal law enforcement agency

The Code permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The Code permits the redisclosure by a Federal law enforcement agency to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.

#### Disclosure upon request from the Departments of Justice or the Treasury for intelligence analysis of terrorist activity

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information) to officers and employees of the Department of Justice, Department of the Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is: (1) an officer or employee of the Department of Justice or the Department of the Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester.

### **Description of Proposal**

The proposal extends for one year (through December 31, 2008) the disclosure authority relating to terrorist activities.

### **Effective Date**

The proposal is effective for disclosures after December 31, 2007.

## **3. Disclosure of return information to carry out income contingent repayment of student loans**

### **Present Law**

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code. An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan. The disclosure authority for the income-contingent loan repayment program is scheduled to expire after December 31, 2007.

The Department of Education utilizes contractors for the income-contingent loan verification program. The specific disclosure exception for the program does not permit disclosure of return information to contractors. As a result, the Department of Education obtains return information from the Internal Revenue Service by taxpayer consent (under section 6103(c)), rather than under the specific exception for the income-contingent loan verification program (sec. 6103(l)(13)).

### **Description of Proposal**

The proposal extends for one year (through December 31, 2008) the present law authority to disclose return information for purposes of the income-contingent loan repayment program.

### **Effective Date**

The proposal applies to requests made after December 31, 2007.

## **4. Extension of IRS authority to fund undercover operations**

### **Present Law**

IRS undercover operations are statutorily<sup>127</sup> exempt from the generally applicable restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the Code permits the IRS to use proceeds from an undercover

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<sup>127</sup> Sec. 7608(c).

operation to pay additional expenses incurred in the undercover operation, through 2007. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations.

### **Description of Proposal**

The proposal extends through 2008 the IRS's authority to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation.

### **Effective Date**

The proposal is effective on the date of enactment.

## **5. Suspend limitation on rate of rum excise tax cover over to Puerto Rico and Virgin Islands**

### **Present Law**

A \$13.50 per proof gallon<sup>128</sup> excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.<sup>129</sup> The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).<sup>130</sup>

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.<sup>131</sup> The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon during the period July 1, 1999 through December 31, 2007).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.<sup>132</sup>

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<sup>128</sup> A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

<sup>129</sup> Sec. 5001(a)(1).

<sup>130</sup> Secs. 5062(b), 7653(b) and (c).

<sup>131</sup> Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

<sup>132</sup> Sec. 7652(e)(2).

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.<sup>133</sup> All of the amounts covered over are subject to the limitation.

### **Description of Proposal**

The proposal suspends for one year the \$10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the proposal, the cover over amount of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2007 and before January 1, 2009. After December 31, 2008, the cover over amount reverts to \$10.50 per proof gallon.

### **Effective Date**

The change in the cover over rate is effective for articles brought into the United States after December 31, 2007.

## **6. Extension of disclosure authority to the Department of Veterans Affairs**

### **Present Law**

The Code prohibits disclosure of returns and return information, except to the extent specifically authorized by the Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service (“IRS”) to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure of certain tax information to the Department of Veterans Affairs. Disclosure is permitted to assist the Department of Veterans Affairs in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The Department of Veterans Affairs disclosure provision was scheduled to expire after September 30, 2008.

### **Description of Proposal**

The proposal extends for three months (through December 31, 2008) the disclosure authority to the Department of Veteran’s Affairs.

### **Effective Date**

The proposal is effective for requests made after September 30, 2008.

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<sup>133</sup> Secs. 7652(a)(3), (b)(3), and (e)(1).

## **V. MORTGAGE FORGIVENESS DEBT RELIEF**

### **A. Exclude Discharges of Acquisition Indebtedness on Principal Residences from Gross Income**

#### **Present Law**

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness (secs. 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities immediately after the discharge (sec. 1017).

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

For example, assume a taxpayer who is not in bankruptcy and is not insolvent owns a principal residence subject to a \$200,000 mortgage debt. If the creditor forecloses and the home is sold for \$180,000 in satisfaction of the debt, the debtor has \$20,000 income from the discharge of indebtedness which is includible in gross income. Likewise, if the creditor restructures the loan and reduces the principal amount to \$180,000, the debtor has \$20,000 includible in gross income.

#### **Description of Proposal**

The proposal excludes from the gross income of a taxpayer any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of section 163(h)(3)(B) except that the dollar limit is \$2 million (\$1 million in the case of a separate return)) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such debt to the extent the amount of the refinancing does not exceed the amount of the refinanced indebtedness. For these purposes the term "principal residence" has the same meaning as under section 121 of the Code.

The basis of the individual's principal residence is reduced by the amount excluded from income under the proposal.

Under the proposal, the exclusion does not apply to a taxpayer in a Title 11 case; instead the present-law exclusion applies. In the case of an insolvent taxpayer not in a Title 11 case, the exclusion under the proposal applies unless the taxpayer elects to have the present-law exclusion apply instead.

Under the proposal, the exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender.

#### **Effective Date**

The proposal is effective for discharges of indebtedness on or after January 1, 2007.

## **B. Extend the Deduction for Private Mortgage Insurance**

### **Present Law**

#### **In general**

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

#### **Acquisition indebtedness and home equity indebtedness**

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is \$100,000. The maximum amount of acquisition indebtedness is \$1 million. Acquisition indebtedness means debt that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

#### **Private mortgage insurance**

Certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction is phased out ratably by 10 percent for each \$1,000 by which the taxpayer's adjusted gross income exceeds \$100,000 (\$500 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds \$110,000 (\$55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2007, or properly allocable to any period after that date.

Reporting rules apply under the provision.

### **Description of Proposal**

The proposal extends the deduction for private mortgage insurance to amounts paid or accrued after December 31, 2007, but only with respect to contracts entered into after December 31, 2006, and prior to January 1, 2015.

### **Effective Date**

The proposal applies to contracts entered into after December 31, 2006, and before January 1, 2015, with respect to amounts paid or accrued after December 31, 2007.

## **C. Alternative Tests for Qualifying as Cooperative Housing Corporation**

### **Present Law**

Under present law, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued to the cooperative to the extent those amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative which are paid or incurred by the cooperative on the cooperative's land or buildings and (2) interest allowable as a deduction to the cooperative that is paid or incurred by the cooperative on its indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, alteration, rehabilitation, or maintenance of the cooperative's buildings.

A cooperative housing corporation generally is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock in the corporation, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on complete or partial liquidation of the cooperative, and (4) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest are paid or accrued is derived from tenant-stockholders.

### **Description of Proposal**

Under the proposal, the fourth requirement listed above is amended to provide that the requirement is met if, for the taxable year in which the taxes and interest are paid or accrued, the corporation meets one of three requirements—(1) 80 percent or more of the corporation's gross income for that taxable year is derived from tenant-stockholders (the present law requirement); (2) at all times during that taxable year 80 percent or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use; or (3) 90 percent or more of the expenditures of the corporation paid or incurred during that taxable year are paid or incurred for the acquisition, construction, management, maintenance, or care of the corporation's property for the benefit of tenant-stockholders.

### **Effective Date**

The proposal applies to taxable years ending after the date of enactment.

## **D. Exclusion of Gain on Sale of a Principal Residence Not to Apply to Nonqualified Use**

### **Present Law**

#### **In general**

Under present law, an individual taxpayer may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Present law also contains an election relating to members of the uniformed services, the Foreign Service, and certain employees of the intelligence community.<sup>134</sup> If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. The election may be made with respect to only one property for a suspension period.

The exclusion does not apply to gain to the extent the gain is attributable to depreciation allowable with respect to the rental or business use of a principal residence for periods after May 6, 1997.

### **Description of Proposal**

Under the proposal, gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

A period of nonqualified use means any period (not including any period before January 1, 2008) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, any period after the last date the property is used as the principal residence of the taxpayer or spouse, and any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen

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<sup>134</sup> The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

circumstances, are not taken into account. The present-law election for the uniformed services, Foreign Service and employees of the intelligence community is unchanged.

If any gain is attributable to post-May 6, 1997, depreciation, the exclusion does not apply to that amount of gain, as under present law, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

The provisions of this proposal may be illustrated by the following examples:

Example 1.—Assume that an individual buys a property on January 1, 2008, for \$400,000, and uses it as rental property for two years claiming \$20,000 of depreciation deductions. On January 1, 2010, the taxpayer converts the property to his principal residence. On January 1, 2012, the taxpayer moves out, and the taxpayer sells the property for \$700,000 on January 1, 2013. As under present law, \$20,000 gain attributable to the depreciation deductions is included in income. Of the remaining \$300,000 gain, 40% of the gain (2 years divided by 5 years), or \$120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of \$180,000 is less than the maximum gain of \$250,000 that may be excluded, gain of \$180,000 is excluded from gross income.

Example 2.—Assume that an individual buys a principal residence on January 1, 2008, for \$400,000, moves out on January 1, 2018, and on December 1, 2020 (more than two years after it was last used as the principal residence) sells the property for \$600,000. The entire \$200,000 gain is excluded from gross income, as under present law.

### **Effective Date**

The proposal is effective for sales and exchanges after December 31, 2007.

## **VI. TAX COLLECTION RESPONSIBILITY**

### **A. Repeal of Private Tax Collection Contracts**

#### **Present Law**

The Secretary has general authority to administer and enforce the tax laws. Present law also provides specific authority for the collection of taxes. Under present law, the IRS may use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type and to arrange payment of those taxes by the taxpayers.<sup>135</sup>

Present law provides for payments to private debt collection companies to be made from the amount collected pursuant to a private debt collection contract, but not in excess of 25 percent of the amount collected. Present law also permits the IRS to retain an amount not in excess of 25 percent from the amount collected pursuant to a private debt collection contract for additional enforcement activities.

#### **Description of Proposal**

The proposal repeals the authority for the IRS to enter into, renew, or extend any private debt collection contract.

#### **Effective Date**

The proposal generally is effective on the date of enactment, except for any contract which was entered into before July 18, 2007, and is not renewed or extended after such date. The proposal also provides that any private debt collection contract which is entered into on or after July 18, 2007, and any extension or renewal on or after such date of any private debt collection contract shall be void.

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<sup>135</sup> Sec. 6306.

## **B. Delayed Implementation of Government Withholding**

### **Present law**

For payments made after December 31, 2010, the Code requires withholding at a three-percent rate on certain payments to persons providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than \$100 million of annual expenditures for property or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement.

Payments subject to the three-percent withholding include any payment made in connection with a government voucher or certificate program which functions as a payment for property or services. For example, payments to a commodity producer under a government commodity support program are subject to the withholding requirement. The provision imposes information reporting requirements on payments subject to withholding under the provision.

The three-percent withholding requirement does not apply to any payments made through a Federal, State, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test. The three-percent withholding requirement also does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law. The provision does not exclude payments that are potentially subject to backup withholding under section 3406. If, however, payments are actually being withheld under backup withholding, the three-percent withholding requirement does not apply.

The three-percent withholding requirement also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)); and payments to a government employee that are not otherwise excludable from the new withholding provision with respect to the employee's services as an employee.

### **Description of Proposal**

The proposal delays the effective date for the three-percent withholding requirement. Under the proposal, the requirement applies to payments made after December 31, 2011.

The proposal directs the Secretary to study issues associated with the three-percent withholding requirement, including (1) the problems, if any, which are anticipated in administering and complying with such requirement, (2) the burdens, if any, that such requirements will place on small businesses (taking into account such mechanisms as may be necessary to administer such requirements), and (3) the application of such requirements to small expenditures for services and goods by governments.

The Secretary is to submit his report to the House Committee on Ways and Means and the Senate Committee on Finance no later than six months after the date of enactment.

**Effective Date**

The proposal is effective on the date of enactment.

## **C. Application of Statute of Limitations Rules to Persons Claiming U.S. Virgin Islands Residency**

### **Present Law**

#### **Return filing rules for Virgin Islands residents**

An individual who is a bona fide resident of the U.S. Virgin Islands (“USVI”) during the entire taxable year or who files a joint return for the taxable year with a person who is a bona fide USVI resident during that entire year must file an income tax return for the taxable year with the USVI.<sup>136</sup>

For an individual (1) who is a bona fide resident of the USVI during the entire taxable year, (2) who, on the income tax return filed with the USVI, reports income from all sources and identifies the source of each item shown on the return, and (3) who fully pays the tax liability resulting from the income shown on the return, for purposes of calculating income tax liability to the United States, gross income does not include any amount included in gross income on the USVI return, and allocable deductions and credits are not taken into account.<sup>137</sup> Accordingly, an individual who is a bona fide USVI resident generally may satisfy the individual’s U.S. return-filing and income tax payment obligations by filing an income tax return with the USVI and paying income tax to the USVI.

#### **Statute of limitations**

The IRS generally must assess tax within three years after the due date for the return to which the assessment relates.<sup>138</sup>

In certain circumstances, the three-year statute of limitations does not apply, and the IRS may assess tax at any time. These circumstances include the filing of a false or fraudulent return with the intent to evade tax; a willful attempt to defeat or evade tax; and the failure to file a return.

#### **Statute of limitations for USVI residents**

In guidance published in 1999, the IRS concluded that when a U.S. citizen who was a bona fide resident of the USVI timely filed a USVI income tax return but failed to report on that return a U.S.-source dividend, the three-year statute of limitations period began to run with the filing of the USVI return and the IRS was precluded from assessing tax after expiration of the three-year period.<sup>139</sup> In 2006 guidance, the IRS concluded that when a U.S. citizen who timely

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<sup>136</sup> Sec. 932(c)(1), (2).

<sup>137</sup> Sec. 932(c)(4).

<sup>138</sup> Sec. 6501(a), (b)(1).

<sup>139</sup> Field Service Advice Memorandum 199906031 (Feb. 12, 1999).

files a USVI income tax return fails to satisfy a requirement of section 932(c)(4) (because, for example, the individual is not a bona fide USVI resident or does not report all income on the USVI return), the three-year statute of limitations period does not begin to run until the individual also files a return with the IRS.<sup>140</sup>

In 2007 guidance, the IRS provided rules for the application of the three-year statute of limitations period and the section 932(c) return filing requirements to a U.S. citizen or resident who claims status as a bona fide USVI resident.<sup>141</sup> As a result of this guidance, for taxable years ending on or after December 31, 2006, the three-year statute of limitations period for every U.S. citizen or resident claiming to be a bona fide USVI resident generally begins when the individual files an income tax return with the USVI.

The rules in the 2007 guidance for an individual who claims bona fide USVI residence for a taxable year ending before December 31, 2006 differ based on whether the individual is a “covered person” or a non-covered person. A covered person is a U.S. citizen or resident alien who takes the position that he or she is a bona fide USVI resident, files a USVI income tax return, and has less than \$75,000 gross income for the taxable year. A covered person generally may claim application of the three-year statute of limitations period for a taxable year ending before December 31, 2006 based on that person’s filing of a USVI income tax return for that year. A non-covered person may start the running of the three-year limitations period for a taxable year ending before December 31, 2006 by filing an income tax return for that year with the IRS and reporting on that return no gross income and no taxable income. The three-year limitations period starts with the filing of the return with the IRS.

### **Description of Proposal**

The proposal provides generally that an income tax return filed with the USVI by an individual claiming to be a bona fide USVI resident during the entire taxable year or, for any taxable year ending on or before October 22, 2004, at the close of that taxable year will be treated for purposes of subtitle F of the Code (Procedure and Administration) in the same manner as if the return were an income tax return filed with the United States for that year. Consequently, under the proposal the filing of a USVI income tax return by any individual claiming status as a bona fide USVI resident generally starts the three-year limitations period. This rule does not, however, apply if the return filed with the USVI is false or fraudulent with the intent to evade tax or otherwise is a willful attempt in any manner to defeat or evade tax.

### **Effective Date**

The proposal applies to taxable years beginning after 1986.

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<sup>140</sup> Chief Counsel Advice Memorandum 200624002 (June 16, 2006).

<sup>141</sup> Notice 2007-19, 2007-11 I.R.B. 689 (Mar. 12, 2007); Notice 2007-31, 2007-16 I.R.B. 971 (Apr. 16, 2007).

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

### **Present Law**

#### **In general**

##### **Income tax**

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.

Certain special rules (sections 671-679) apply to certain trust interests deemed to be owned by the grantor or other person (a “grantor trust”). In that case, the deemed owner must include in income the items of income and deduction (and credits against tax) of the portion of such trust deemed to be owned by such person.

Except to the extent a trust is a grantor trust, a transfer of property by a U.S. person to a foreign estate or trust is treated (under section 684) by the transferor as if the property had been sold to such estate or trust. The same rule applies if a domestic trust becomes a foreign trust.

##### **Estate tax**

The estates of U.S. citizens and residents are subject to estate tax on all property, wherever located. 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).

##### **Gift tax**

U.S. citizens and residents generally are subject to gift tax on transfers by gift of any property, wherever situated. 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>142</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 may require.

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

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

Special estate tax rules apply to individuals who die during a taxable year in which they are 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, the former citizen or former long-term resident: (1) owns, directly or indirectly, 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote; and (2) is considered to own, directly or indirectly, more than 50 percent of (a) the total combined voting power of all classes of stock of the foreign corporation entitled to vote, 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 they are 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

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<sup>142</sup> For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

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 to the U.S. presence rules for residency purposes<sup>143</sup> generally do not apply. However, for individuals with certain ties to countries other than the United States<sup>144</sup> and

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<sup>143</sup> Secs. 7701(b)(3)(D), 7701(b)(5), and 7701(b)(7)(B)-(D).

<sup>144</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.

individuals with minimal prior physical presence in the United States,<sup>145</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)), that meets such requirements as the Secretary 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 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.

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**

In general, the proposal imposes tax on certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residency. Such individuals are subject to income tax on the net unrealized gain in their property as if the property had been sold for its 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. The \$600,000 amount is increased by a cost of living adjustment factor for calendar years after 2008. Any gains or losses subsequently realized are to be adjusted for gains and losses taken into account under the deemed sale rules, without regard to the \$600,000 exemption.

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<sup>145</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).

The mark-to-market tax described above applies to most types of property interests held by the individual on the date of relinquishment of citizenship or termination of residency, with certain exceptions. Deferred compensation items, interests in nongrantor trusts, and specified tax deferred accounts are excepted from the mark-to-market tax but are subject to the special rules described below.

In addition, the proposal imposes a transfer tax on certain transfers to U.S. persons from certain U.S. citizens who relinquished their U.S. citizenship and certain long-term U.S. residents who terminated their U.S. residency, or from their estates.

### **Individuals covered**

The proposal applies to any U.S. citizen who relinquishes citizenship and any long-term resident who terminates U.S. residency, if such individual (“covered expatriate”) (1) has an average annual net income tax liability for the five preceding years ending before the date of the loss of U.S. citizenship or residency termination that exceeds \$124,000 (as adjusted for inflation after 2004 – \$136,000 in 2007<sup>146</sup>); (2) has a net worth of \$2 million or more on such date; or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years or fails to submit such evidence of compliance as the Secretary may require.

Exceptions to an individual’s classification as a covered expatriate due to (1) or (2) above (but not (3)) 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 has been a resident of the United States (under the substantial presence test of section 7701(b)(1)(A)(ii)) for not more than 10 taxable years during the 15-year taxable year period ending with the taxable 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 (under the substantial presence test of section 7701(b)(1)(A)(ii)) for no more than 10 taxable years before such relinquishment.

The definition of “long-term resident” under the proposal is generally the same as that under present law. As under present law, an individual is considered to terminate long-term U.S. residency when the individual ceases to be a lawful permanent resident of the United States (i.e., loses his or her green card status through revocation or has been administratively or judicially determined to have abandoned such status). Under the proposal, however, an individual ceases to be treated as a lawful permanent resident of the United States for all tax purposes (including for purposes of section 877) if such individual commences to be treated as a resident of a foreign country under a tax treaty between the United States and such foreign country, does not waive the benefits of the treaty applicable to residents of such foreign country, and notifies the Secretary of the commencement of such treatment.

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<sup>146</sup> Rev. Proc. 2006-53, sec. 3.29, 2006-48 I.R.B. 996.

The proposal provides that, for all tax purposes (including for purposes of section 877), 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. For purposes of the proposal, 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 the case of a long-term resident, the date that long-term residency is terminated is the "expatriation date." In the case of a citizen, the date that the individual relinquishes citizenship is the "expatriation date."

The foregoing rules replace the present-law rules that provide that an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes until the individual gives notice of an expatriating act or termination of residency.

If an individual who is a covered expatriate becomes subject to tax as a citizen or resident of the United States for any period beginning after the expatriation date, the individual is not treated as a covered expatriate during that period for purposes of applying the withholding rules relating to deferred compensation items, the rules relating to interests in nongrantor trusts, and the rules relating to gifts and bequests from covered expatriates. If the individual again relinquishes citizenship or terminates long-term residency (after meeting anew the requirements to become a long-term resident), the mark-to-market tax and other proposals are re-triggered with the new expatriation date.

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

Under the proposal, an individual may 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 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 return is due for the taxable year in which the property is disposed (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 may prescribe). The deferred tax attributable to a particular property is an amount which 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 for the mark-to-market tax. 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 furnish a bond to the Secretary. The bond must be conditioned upon payment of the amount of tax due, plus interest thereon, and must be in accordance with such requirements relating to terms, conditions, form of the bond, and sureties, as may be specified by regulations. The bond must be accepted by the Secretary. Other security mechanisms, including letters of credit, are permitted provided that they meet such requirements as the Secretary may prescribe. In the event that the security provided with respect to a particular property subsequently fails to meet the requirements of these rules and the individual fails to correct such failure, 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 assessment or collection of the tax.

### **Deferred compensation items**

The proposal contains special rules for interests in deferred compensation items. For purposes of the proposal, a “deferred compensation item” means any interest in a plan or arrangement described in section 219(g)(5), any interest in a foreign pension plan or similar retirement arrangement or program, any item of deferred compensation, and any property, or right to property, which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under section 83 or in accordance with section 83.

The plans and arrangements described in section 219(g)(5) are (i) a plan described in section 401(a), which includes a trust exempt from tax under section 501(a); (ii) an annuity plan described in section 403(a); (iii) a plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, but excluding an eligible deferred compensation plan (within the meaning of section 457(b)); (iv) an annuity contract described in section 403(b); (v) a simplified employee pension (within the meaning of section 408(k)); (vi) a simplified retirement account (within the meaning of section 408(p)); and (vii) a trust described in section 501(c)(18).

If a deferred compensation item is an eligible deferred compensation item, the payor must deduct and withhold from a “taxable payment” to the covered expatriate a tax equal to 30 percent of such taxable payment. This withholding requirement is in lieu of any withholding requirement under present law. A taxable payment is subject to withholding to the extent it would be included in gross income of the covered expatriate if such person were subject to tax as a citizen or resident of the United States. A deferred compensation item is taken into account as a payment when such item would be so includible. A deferred compensation item that is subject to the 30 percent withholding requirement is subject to tax under section 871.

If a deferred compensation item is not an eligible deferred compensation item, an amount equal to the present value of the covered expatriate’s deferred compensation item is treated as having been received on the day before the expatriation date. In the case of a deferred compensation item that is subject to section 83, the item is treated as becoming transferable and no longer subject to a substantial risk of forfeiture on the day before the expatriation date. Appropriate adjustments shall be made to subsequent distributions to take into account the foregoing treatment. In addition, these deemed distributions are not subject to early distribution

tax. For this purpose, “early distribution tax” means any increase in tax imposed under section 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), or 530(d)(4).

An “eligible deferred compensation item” means any deferred compensation item with respect to which (i) the payor is either a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of withholding and who meet the requirements prescribed by the Secretary to ensure compliance with the withholding requirements, and (ii) the covered expatriate notifies the payor of his status as a covered expatriate and irrevocably waives any claim of withholding reduction under any treaty with the United States.

The foregoing taxing rules regarding eligible deferred compensation items and items that are not eligible deferred compensation items do not apply to deferred compensation items that are attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States.

### **Specified tax deferred accounts**

There are special rules for interests in specified tax deferred accounts. If a covered expatriate holds any interest in a specified tax deferred account on the day before the expatriation date, such covered expatriate is treated as receiving a distribution of his entire interest in such account on the day before the expatriation date. Appropriate adjustments are made for subsequent distributions to take into account this treatment. As with deferred compensation items, these deemed distributions are not subject to early distribution tax.

The term “specified tax deferred account” means an individual retirement plan (as defined in section 7701(a)(37)), a qualified tuition plan (as defined in section 529), a Coverdell education savings account (as defined in section 530), a health savings account (as defined in section 223), and an Archer MSA (as defined in section 220). However, simplified employee pensions (within the meaning of section 408(k)) and simplified retirement accounts (within the meaning of section 408(p)) of a covered expatriate are treated as deferred compensation items and not as specified tax deferred accounts.

### **Interests in trusts**

#### **Grantor trusts**

In the case of the portion of any trust for which the covered expatriate is treated as the owner under the grantor trust provisions of the Code, as determined immediately before the expatriation date, the assets held by that portion of the trust are subject to the mark-to-market tax. If a trust that is a grantor trust immediately before the expatriation date subsequently becomes a nongrantor trust, such trust remains a grantor trust for purposes of the proposal.

#### **Nongrantor trusts**

Special rules apply to trusts with respect to which the covered expatriate is a beneficiary on the day before the expatriation date. The mark-to-market tax does not apply with respect to the portion of any such trust not treated (under the grantor trust provisions of the Code) as owned by a covered expatriate immediately before the expatriation date. Instead, in the case of any

direct or indirect distribution from such a portion of a trust (“nongrantor trust”) to a covered expatriate, the trustee must deduct and withhold from the distribution an amount equal to 30 percent of the portion of the distribution which would be includible in the gross income of the covered expatriate if the covered expatriate continued to be subject to tax as a citizen or resident of the United States. Such portion of such distribution (that is subject to the 30 percent withholding requirement) is subject to tax under section 871. The covered expatriate is treated as having waived any right to claim any reduction in withholding under any treaty with the United States.

In addition, if the nongrantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at its fair market value.

If a trust that is a nongrantor trust immediately before the expatriation date subsequently becomes a grantor trust of which a covered expatriate is treated as the owner, directly or indirectly, such conversion is treated under the proposal as a distribution to such covered expatriate to the extent of the portion of the trust of which the covered expatriate is treated as the owner.

### **Special rules**

Notwithstanding any other provision of the Code, any period for acquiring property which results in the reduction of gain recognized with respect to property disposed of by the taxpayer terminates on the day before the expatriation date. This rule applies to certain incomplete transactions such as deferred like-kind exchanges and involuntary conversions. 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.

For purposes of determining the tax imposed under the mark-to-market tax, property that was held by an individual on the date that such individual first became a resident of the United States (within the meaning of section 7701(b)) is treated as having a basis on such date of not less than the fair market value of such property on such date. An individual may make an irrevocable election not to have this rule apply.

In the case of a domestic trust that becomes a foreign trust due to the expatriation of an individual, the general income tax rules pertaining to transfers by U.S. persons to foreign trusts (i.e., section 684) apply before the rules of the proposal.

### **Regulatory authority**

The proposal authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the income tax rules of the proposal.

## **Treatment of gifts and bequests from a former citizen or former long-term resident**

Under the proposal, a special transfer tax applies to certain “covered gifts or bequests” received by a U.S. citizen or resident. A covered gift or bequest is any property acquired (i) by gift directly or indirectly from an individual who is a covered expatriate at the time of such acquisition, or (ii) directly or indirectly by reason of the death of an individual who was a covered expatriate. A covered gift or bequest, however, does not include (i) any property shown as a taxable gift on a timely filed gift tax return by the covered expatriate, and (ii) any property included in the gross estate of the covered expatriate for estate tax purposes and shown on a timely filed estate tax return of the estate of the covered expatriate.

The tax is calculated as the product of (i) the highest marginal rate of tax specified in the table applicable to estate tax (i.e., section 2001(c)) or, if greater, the highest marginal rate of tax specified in the table applicable to gift tax (i.e., section 2502(a)), both as in effect on the date of receipt of the covered gift or bequest; and (ii) the value of the covered gift or bequest.

The tax is imposed upon the recipient of the covered gift or bequest and is imposed on a calendar-year basis. The tax applies to a recipient of a covered gift or bequest only to the extent that the total value of covered gifts and bequests received by such recipient during a calendar year exceeds \$10,000. The tax on covered gifts and bequests is reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest.

Special rules apply to the tax on covered gifts or bequests made to domestic or foreign trusts. In the case of a covered gift or bequest made to a domestic trust, the tax applies as if the trust is a U.S. citizen, and the trust is required to pay the tax. In the case of a covered gift or bequest made to a foreign trust, the tax applies to any distribution from such trust (whether from income or corpus) attributable to such covered gift or bequest to a recipient that is a U.S. citizen or resident, in the same manner as if such distribution were a covered gift or bequest. Such a recipient is entitled to deduct the amount of such tax for income tax purposes to the extent such tax is imposed on the portion of such distribution that is included in the gross income of the recipient. For purposes of these rules, a foreign trust may elect to be treated as a domestic trust. The election may not be revoked without the Secretary’s consent.

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

Under the proposal, the present-law expatriation income tax rules under section 877 generally continue to apply to a covered expatriate whose expatriation or residency termination occurs before, 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.

## **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. However, the

portion of the proposal relating to covered gifts and bequests is effective for gifts and bequests received from former citizens or former long-term residents (or their estates) on or after the date of enactment, regardless of when the transferor expatriated.

## **E. Repeal of Provision Regarding Suspension of Interest and Penalties**

### **Present Law**

In general, interest and penalties accrue during periods for which taxes were unpaid without regard to whether the taxpayer was aware that there was tax due. Prior to amendment by the Small Business and Work Opportunity Tax Act of 2007, the accrual of certain penalties and interest is suspended starting 18 months after the filing of the tax return if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. If a tax return is filed before the due date, for purposes of interest suspension it is considered to have been filed on the due date. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension only applies to individuals who file a timely tax return. The provision does not apply to the following: the penalty for failing to pay; any interest, penalty, addition to tax, or additional amount in a case involving fraud; any interest, penalty, addition to tax, or additional amount with respect to any gross misstatement; and any criminal penalty. Generally, the suspension of interest also does not apply to interest accruing with respect to underpayments resulting from listed transactions or undisclosed reportable transactions.

For IRS notices issued after November 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 provides that the accrual of penalties and interest is suspended starting 36 months after the filing of the tax return.<sup>147</sup> Because the general statute of limitations on assessment of tax is 36 months after the filing of a tax return, the effect of the provision in the Small Business and Work Opportunity Tax Act of 2007 is that interest suspension only applies to tax liabilities eligible for suspension which may be assessed more than three years after the filing of the tax return to which the liability relates.

### **Description of Proposal**

The proposal repeals the suspension of interest and certain penalties provision. Thus, the effect of the proposal is to eliminate interest suspension for liabilities which may be assessed more than three years after the filing of a tax return.

### **Effective Date**

The proposal is effective for IRS notices issued after the date which is 6 months after the date of the enactment of the Small Business and Work Opportunity Tax Act of 2007 (November 25, 2007).

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<sup>147</sup> Pub. L. No. 110-28, sec. 7542 (2007).

## VII. REVENUE RAISING PROVISIONS

### A. Offshore Nonqualified Deferred Compensation

#### Present Law

##### In general

Under present law, the determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the person earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,<sup>148</sup> the provisions of section 83 relating generally to transfers of property in connection with the performance of services, provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)), and the requirements of section 409A.

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation generally is includible in income by a cash-basis taxpayer when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

An arrangement generally is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.<sup>149</sup> Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor; for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts generally are not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

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<sup>148</sup> See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd, per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

<sup>149</sup> Treas. Reg. sec. 1.83-3(e). This definition, in part, reflects previous IRS rulings on nonqualified deferred compensation.

As discussed above, if the arrangement is unfunded, then the compensation generally is includible in income by a cash-basis taxpayer when it is actually or constructively received under section 451.<sup>150</sup> Income is constructively received when it is credited to a person's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Prior to the enactment of section 409A, arrangements had developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion under the constructive receipt doctrine (which applies to unfunded arrangements). One such arrangement is a "rabbi trust." A rabbi trust is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy. In the case of a rabbi trust, these terms have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.<sup>151</sup> As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

## **Section 409A**

### Reason for enactment

The Congress enacted section 409A<sup>152</sup> because it was concerned that many nonqualified deferred compensation arrangements had developed which allowed improper deferral of income. Executives often used arrangements that allowed deferral of income, but also provided security of future payment and control over amounts deferred. For example, nonqualified deferred compensation arrangements often contained provisions that allowed participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a "haircut" provision). In addition, Congress was aware that since the concept of a rabbi trust was developed, techniques had been used that attempted to protect the assets from creditors despite the terms of the trust. For example, the trust or fund would be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.

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<sup>150</sup> Treas. Reg. secs. 1.451-1 and 1.451-2.

<sup>151</sup> This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence, the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

<sup>152</sup> Section 409A was added to the Code by sec. 885 of the American Job Creation Act of 2004, Pub. L. No. 108-357.

Prior to the enactment of section 409A, while the general tax principles governing deferred compensation were well established, the determination whether a particular arrangement effectively allowed deferral of income was generally made on a facts and circumstances basis. There was limited specific guidance with respect to common deferral arrangements. The Congress believed that it was appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted and to provide a clear set of rules that would apply to these arrangements. The Congress believed that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion. The Congress also believed that certain arrangements, such as offshore trusts, which effectively protect assets from creditors of the employer, should be treated as funded and not result in deferral of income inclusion to the extent the amounts are vested.

#### General requirements of section 409A

In general.—Under section 409A, all amounts deferred by a service provider under a nonqualified deferred compensation plan<sup>153</sup> for all taxable years are currently includible in gross income of the service provider to the extent such amounts are not subject to a substantial risk of forfeiture<sup>154</sup> and not previously included in gross income, unless certain requirements are satisfied. If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the rate applicable to underpayments of tax 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.

Section 409A does not limit the amount that may be deferred under a nonqualified deferred compensation plan. The Secretary of the Treasury is authorized to prescribe regulations as are necessary or appropriate to carry out the purposes of section 409A. The Secretary of the Treasury issued final regulations under section 409A on April 17, 2007.

Under these regulations, the term “service provider” includes an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in section 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, or qualified personal service corporation (as defined in section 448(d)(2)) for any taxable year in which such individual or entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting.<sup>155</sup> Section 409A does not apply to a service provider that provides significant services to at least two service recipients that are not related to each other or the service provider. This exclusion does not apply

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<sup>153</sup> A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

<sup>154</sup> As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person’s rights to such compensation are conditioned upon the performance of substantial services by any individual.

<sup>155</sup> Treas. Reg. sec. 1.409A-1(f)(1).

to a service provider who is an employee or a director of a corporation (or similar position in the case of an entity that is not a corporation).<sup>156</sup> In addition, the exclusion does not apply to an entity that operates as the manager of a hedge fund or private equity fund. This is because the exclusion does not apply to the extent that a service provider provides management services to a service recipient. Management services for this purpose means services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets, such as a hedge fund.<sup>157</sup>

Permissible distribution events.—Under section 409A, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary of the Treasury), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary of the Treasury), occurrence of an unforeseeable emergency, or if the service provider becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary of the Treasury, may not permit acceleration of a distribution. In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees<sup>158</sup> of publicly-traded corporations.

Elections.—Section 409A requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the service provider's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. The time and form of distributions must be specified at the time of initial deferral. A plan may allow changes in the time and form of distributions subject to certain requirements.

Back-to-back arrangements.—Back-to-back service recipients (i.e., situations under which an entity receives services from a service provider such as an employee, and the entity in turn provides services to a client) that involve back-to-back nonqualified deferred compensation arrangements (i.e., the fees payable by the client are deferred at both the entity level and the employee level) are subject to special rules under section 409A. For example, the final regulations generally permit the deferral agreement between the entity and its client to treat as a permissible distribution event those events that are specified as distribution events in the deferral

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<sup>156</sup> Treas. Reg. sec. 1.409A-1(f)(2).

<sup>157</sup> Treas. Reg. sec. 1.409A-1(f)(2)(iv).

<sup>158</sup> Key employees are defined in section 416(i) and generally include officers (limited to 50 employees) having annual compensation greater than \$145,000 (for 2007), five percent owners, and one percent owners having annual compensation from the employer greater than \$150,000.

agreement between the entity and its employee. Thus, if separation from employment is a specified distribution event between the entity and the employee, the employee's separation generally is a permissible distribution event for the deferral agreement between the entity and its client.<sup>159</sup>

Offshore funding arrangements.—Section 409A requires current income inclusion in the case of certain offshore funding of nonqualified deferred compensation. Under section 409A, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary of the Treasury) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property.

Interest at the underpayment rate plus one percentage point is imposed on the underpayments of tax that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income also is subject to an additional 20-percent tax.

The special funding rule does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The Secretary of the Treasury has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

#### Definition of substantial risk of forfeiture

Under the Treasury regulations, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned upon either the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, provided that the possibility of forfeiture is substantial.<sup>160</sup>

#### Definition of nonqualified deferred compensation

Under section 409A, 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

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<sup>159</sup> Treas. Reg. sec. 1.409A-3(i)(6).

<sup>160</sup> Treas. Reg. sec. 1.409A-1(d)(1).

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.

The Treasury regulations also provide that certain other types of plans are not considered deferred compensation, and thus are not subject to section 409A. For example, if a service recipient transfers property to a service provider, there is no deferral of compensation merely because the value of the property is not includible in income under section 83 by reason of the property being substantially nonvested.<sup>161</sup> Another exception applies to amounts that are not deferred beyond a short period of time after the amount is no longer subject to a substantial risk of forfeiture.<sup>162</sup> Under this exception, there generally is no deferral for purposes of section 409A if the service provider actually or constructively receives the amount on or before the last day of the applicable 2½ month period. The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of: (1) the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; or (2) the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

Special rules apply in the case of stock appreciation rights ("SARs").<sup>163</sup> Under the final Treasury regulations, a SAR is a right to compensation based on the appreciation in value of a specified number of shares of service recipient stock occurring between the date of grant and the date of exercise of such right. The final regulations generally provide that a SAR does not result in a deferral of compensation for purposes of section 409A (and thus is not subject to section 409A) if the compensation payable under the SAR is not greater than the excess of the fair market value of the underlying stock on the date the SAR is exercised over the fair market value of the underlying stock on the date the SAR is granted.<sup>164</sup>

The Treasury regulations provide exclusions from the definition of nonqualified deferred compensation in the case of services performed by individuals who participate in certain foreign plans, including plans covered by an applicable treaty and broad-based foreign retirement plans.<sup>165</sup> In the case of a U.S. citizen or lawful permanent alien, nonqualified deferred compensation plan does not include a broad-based foreign retirement plan, but only with respect to the portion of the plan that provides for nonelective deferral of foreign earned income and subject to limitations on the annual amount deferred under the plan or the annual amount payable under the plan. In general, foreign earned income refers to amounts received by an individual from sources within a foreign country that constitutes earned income attributable to services.

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<sup>161</sup> Treas. Reg. sec. 1.409A-1(b)(6).

<sup>162</sup> Treas. Reg. sec. 1.409A-1(b)(4).

<sup>163</sup> Treas. Reg. sec. 1.409A-1(b)(5).

<sup>164</sup> Treas. Reg. sec. 1.409A-1(b)(5)(i)(B).

<sup>165</sup> Treas. Reg. sec. 1.409A-1(a)(3).

### **Timing of the service recipient's deduction**

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.<sup>166</sup> Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the service provider is deductible by the service recipient for the taxable year in which the amount is includible in the service provider's income.<sup>167</sup> Thus, for example, in the case of an unfunded nonqualified deferred compensation plan, a deduction to the taxable service recipient is deferred until the deferred compensation is actually paid or made available to the service provider.

### **Description of Proposal**

Under the proposal, any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income by the service provider when there is no substantial risk of forfeiture of the service provider's rights to such compensation. The proposal applies in addition to the requirements of section 409A (or any other provision of the Code or general tax law principle) with respect to nonqualified deferred compensation.

For purposes of the proposal, the term nonqualified deferred compensation is defined in the same manner as for purposes of section 409A. As under section 409A, the term nonqualified deferred compensation includes earnings with respect to previously deferred amounts. Under the proposal, nonqualified deferred compensation includes any arrangement under which compensation is based on the increase in value of a specified number of equity units of the service recipient. Thus, stock appreciation rights (SARs) are treated as nonqualified deferred compensation under the proposal, regardless of the exercise price of the SAR.

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<sup>166</sup> Secs. 404(a)(5), (b) and (d) and sec. 83(h).

<sup>167</sup> In the case of a publicly held corporation, no deduction is allowed for a taxable year for remuneration with respect to a covered employee to the extent that the remuneration exceeds \$1 million. Code sec. 162(m). The Code defines the term "covered employee" in part by reference to Federal securities law. In light of changes to Federal securities law, the Internal Revenue Service interprets the term covered employee as the principal executive officer of the taxpayer as of the close of the taxable year or the 3 most highly compensated employees of the taxpayer for the taxable year whose compensation must be disclosed to the taxpayer's shareholders (other than the principal executive officer or the principal financial officer). Notice 2007-49, 2007-25 I.R.B. 1429. For purposes of the deduction limit, remuneration generally includes all remuneration for which a deduction is otherwise allowable, although commission-based compensation and certain performance-based compensation are not subject to the limit. Remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of the compensation is deferred until after termination of employment.

The term nonqualified entity includes certain foreign corporations and certain partnerships (either domestic or foreign). A foreign corporation is a nonqualified entity unless substantially all of such income is effectively connected with the conduct of a United States trade or business or is subject to a comprehensive foreign income tax. A partnership is a nonqualified entity unless substantially all of such income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive income tax and organizations which are exempt from U.S. income tax.

The term comprehensive foreign income tax means with respect to a foreign person, the income tax of a foreign country if (1) such person is eligible for the benefits of a comprehensive income tax treaty between such foreign country and the United States, or (2) such person demonstrates to the satisfaction of the Secretary of the Treasury that such foreign country has a comprehensive income tax. A comprehensive foreign income tax does not include any tax unless the tax includes rules for the deductibility of deferred compensation which are similar to the rules under the Code.

For purposes of the proposal, compensation of a service provider is subject to a substantial risk of forfeiture only if such person's right to the compensation is conditioned upon the future performance of substantial services by any person. Thus, compensation is subject to a substantial risk of forfeiture only if entitlement to the compensation is conditioned on the performance of substantial future services and the possibility of forfeiture is substantial. Substantial risk of forfeiture does not include a condition related to a purpose of the compensation (other than future performance of substantial services), regardless of whether the possibility of forfeiture is substantial.

Under the proposal, if the amount of any deferred compensation is not ascertainable at the time that such compensation is otherwise required to be taken into account into income under the proposal, the amount is taken into account when such amount becomes ascertainable. In addition, the income tax with respect to such amount is increased by the sum of (1) an interest charge, and (2) an amount equal to 20 percent of such compensation. The interest charge is equal to the interest at the rate applicable to underpayments of tax plus one percentage point 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.

It is intended that the Secretary of the Treasury issue regulations as to when an amount is unascertainable for purposes of the proposal. It is intended that an amount of deferred compensation is unascertainable at the time the amount is no longer subject to a substantial risk of forfeiture if the amount varies depending on the satisfaction of an objective condition. For example, if a deferred amount varies depending on the satisfaction of an objective condition at the time the amount is no longer subject to substantial risk of forfeiture (e.g., 20 percent of the amount is paid if a certain threshold is achieved, 100 percent is paid if a higher threshold is achieved, and 200 percent is paid if a still higher threshold is achieved), the amount deferred is unascertainable.

Under the proposal, the Secretary of the Treasury is authorized to issue such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations disregarding a substantial risk of forfeiture as necessary to carry out such purposes.

### **Effective Date**

The proposal is effective with respect to amounts deferred which are attributable to services performed after December 31, 2007. In the case of an amount deferred which is attributable to services performed on or before December 31, 2007, to the extent such amount is not includible in gross income in a taxable year beginning before 2017, then such amount is includible in gross income in the later of (1) the last taxable year beginning before 2017, or (2) the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation.

No later than 60 days after date of enactment, the Secretary shall issue guidance providing a limited period of time during which a nonqualified deferred compensation arrangement attributable to services performed on or before December 31, 2007, may, without violating the requirements of section 409A(a), be amended to conform the date of distribution to the date the amounts are required to be included in income.

**B. Income of Partners for Performing  
Investment Management Services Treated as  
Ordinary Income Received for Performance of Services**

**Present Law**

**Partnership profits interest for services**

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership in exchange for the performance of services has been the subject of controversy. In general, a taxpayer receiving a profits interest for performing services has not been taxable upon the receipt of the partnership interest.<sup>168</sup>

In 1993, the Internal Revenue Service, referring to the results of cases, specifically ruled that the receipt of a partnership profits interests for services generally is not a taxable event for the partnership or the partner.<sup>169</sup> Under the ruling, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. A more recent ruling<sup>170</sup> clarifies that this result applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.<sup>171</sup>

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating the receipt of property for the performance of services.<sup>172</sup> A partnership capital interest for this purpose is an interest that

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<sup>168</sup> Only a handful of cases have ruled on this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T. C. (1971), *aff'd* 492 F. 2d 286 (7<sup>th</sup> Cir, 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner* (943 F. 2d. 815 (8<sup>th</sup> Cir. 1991))).

<sup>169</sup> Rev. Proc. 93-27, 1993-2 C.B. 343, citing the *Diamond* and *Campbell* cases, *supra*.

<sup>170</sup> Rev. Proc. 2001-43 (2001-2 C.B. 191).

<sup>171</sup> A similar result would occur under the 'safe harbor' election of proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

<sup>172</sup> Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1); see *U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert denied*, 380 U.S. 961 (1965).

would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.<sup>173</sup>

### **Passthrough tax treatment of partnerships**

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.<sup>174</sup> Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower income tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Amounts distributed to the partner by the partnership are taxed to the extent the amount exceeds the partner's basis in the partnership interest.

### **Employment tax treatment of partners**

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").<sup>175</sup> A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").<sup>176</sup>

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.40 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.<sup>177</sup> The amount of wages subject to this component is capped at \$97,500 for 2007. Under the hospital insurance component ("HI"), the rate is 2.90 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.<sup>178</sup>

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<sup>173</sup> Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>174</sup> Section 702.

<sup>175</sup> See Chapter 21 of the Code.

<sup>176</sup> Sec. 1401.

<sup>177</sup> Secs. 3101 and 3111.

<sup>178</sup> S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.40 percent and the amount of earnings subject to this component is capped at \$97,500 (for 2007). Under the HI component, the rate is 2.90 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.<sup>179</sup> Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rents and dividends, as described above). This rule applies to individuals who are general partners. A special rule applies for limited partners of a partnership.<sup>180</sup> In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

### **Income tax treatment of publicly traded partnerships**

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704(a)). For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

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tax or are properly characterized as another type of income (typically, dividends) and therefore not subject to FICA tax.

<sup>179</sup> For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes (sec. 164(f)).

<sup>180</sup> Sec. 1402(a)(13).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

The rules generally treating publicly traded partnerships as corporations were enacted in 1987 to address concern about long-term erosion of the corporate tax base. At that time, Congress stated, “[t]o the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.” (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065.) Referring to recent tax law changes affecting corporations, the Congress stated, “[t]hese changes reflect an intent to preserve the corporate level tax. The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax.” (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1066.)

### **Real estate investment trusts (REITs)**

A real estate investment trust (“REIT”) is an entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income (other than net capital gain) to its investors before the end of its taxable year.

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the “95-percent income test”). In addition, at least 75 percent of its income generally must be from certain real estate sources (the “75-percent income test”), including rents from real property (as defined) and gain from the sale or other disposition of real property. Amounts received as impermissible “tenant services

income” are not treated as rents from real property.<sup>181</sup> In general, such amounts are for services rendered to tenants that are not “customarily furnished” in connection with the rental of real property. In addition, at least 75 percent of the value of its total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities, and maximum percentages apply to ownership of other types of securities (the “asset test”).

### **Description of Proposal**

#### **Recharacterization as ordinary income for performance of services**

The provision generally treats net income from an investment services partnership interest as ordinary income for the performance of services to the extent the income is not with respect to invested capital. Thus, the provision can recharacterize a portion of the partner's distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income in the hands of the partner. Such income is taxed at ordinary income rates and is subject to self-employment tax.

Net income means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year.

The provision provides that an investment services partnership interest is a partnership interest held by any person who provides (directly or indirectly) a substantial quantity of certain services to the partnership in the conduct of the trade or business of providing such services. The services are: (1) advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset; (2) managing, acquiring, or disposing of any specified asset; (3) arranging financing with respect to acquiring specified assets; (4) any activity in support of any of the foregoing services.

For this purpose, specified assets means securities (as defined in section 475(c)(2)), real estate, commodities (as defined in section 475(e)(2)), or options or derivative contracts with respect to such securities, real estate, or commodities. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether

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<sup>181</sup> A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means a (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified.

### **Exception for invested capital**

The provision provides an exception to recharacterization as ordinary income for performance of services in the case of the portion of the partner's distributive share of partnership items with respect to the partner's invested capital. Invested capital means the fair market value at the time of contribution of any money or other property contributed to the partnership. The exception applies provided that the partnership makes reasonable allocation of partnership items between the portion of the partner's distributive share attributable to invested capital and the remaining portion. An allocation is not treated as reasonable if it would result in the allocation of a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital. The exception to recharacterization also applies to gain or loss attributable to invested capital on disposition of the partnership interest, which is the portion that would have been allocable to invested capital if the partnership had sold all its assets immediately before the disposition.

For this purpose, an investment services partnership interest is not treated as acquired by contribution of invested capital to the extent of any loan or other advance made or guaranteed, directly or indirectly, by any partner or the partnership. For example, if partner A loans partner B funds that partner B contributes to the partnership, the loaned amount is not invested capital of partner B.

In addition, for this purpose, any loan or other advance to the partnership made or guaranteed, directly or indirectly by a partner not providing services to the partnership is treated as invested capital of that partner. Income and loss treated as allocable to invested capital are adjusted accordingly. For example, if investors in a private equity fund that is a partnership contribute capital as debt rather than as equity, while the manager of the fund contributes only equity so that his invested capital appears to be a large percentage of the total equity contributed, the provision treats the partnership debt to the investors as the investors' invested capital. The percentage of total invested capital that is attributable to the fund manager in this example is determined taking into account this debt as well as the equity contributed to the fund, so the manager's invested capital is a smaller percentage of total invested capital than if only equity contributions were taken into account.

### **Losses, dispositions, and partnership distributions**

The provision provides rules for the treatment of losses with respect to an investment services partnership interest, as well as for disposition of all or a portion of such a partnership interest, and distributions of partnership property with respect to such a partnership interest.

Consistently with the general rule providing that net income with respect to such a partnership interest is ordinary income for the performance of services, the provision provides that net loss with respect to such a partnership interest (to the extent not disallowed) generally is treated as ordinary loss. For this purpose, net loss means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year. The net loss is allowed for a partnership taxable year, however, only to the extent that the loss does not exceed the excess (if any) of (1) aggregate net income with respect to the partnership interest for prior partnership taxable years, over (2) the aggregate net loss with respect to the partnership interest not disallowed for prior partnership years. Any net loss that is not allowed for the partnership taxable year is carried forward to the next partnership taxable year. Notwithstanding the present-law rule that the basis of a partnership interest generally is reduced by the partner's distributive share of partnership losses and deductions (sec. 705(a)(2)), the provision provides that no adjustment is made to the basis of a partnership interest on account of a net loss that is not allowed for the partnership taxable year. When any such net loss that is carried forward is allowed in a subsequent year, the adjustment is made to the basis of the partnership interest.

Net loss with respect to an investment services partnership interest that was acquired by purchase, however, is not treated as ordinary, to the extent of net loss not exceeding the excess of (1) the basis of the interest immediately after the purchase, over (2) the aggregate net loss not treated as ordinary under this rule in prior taxable years. Such net loss is not taken into account in determining the amount of net income that is treated as ordinary under the provision.

On the disposition of an investment services partnership interest, gain is treated as ordinary income for the performance of services, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest generally is considered as capital gain or loss (sec. 741; except ordinary treatment applies to the extent attributable to inventory and unrealized receivables, sec. 751). Loss on the disposition of an investment services partnership interest is treated as ordinary loss, but only to the extent of the amount by which aggregate net income previously treated as ordinary exceeds aggregate net loss previously allowed as ordinary under the provision. The amount of net loss that otherwise would have reduced the basis of the investment services partnership interest is disregarded for purposes of the provision, in the event of any disposition of the interest.

On the distribution of appreciated property by a partnership to a partner with respect to an investment services partnership interest, the present-law rule providing that no gain or loss generally is recognized to a partnership on a distribution to a partner of property or money does not apply. Rather, the partnership recognizes gain as if the partnership had sold the property at its fair market value at the time of the distribution. For this purpose, appreciated property means property with respect to which gain would be realized if sold by the partnership at the time of distribution.

In applying the present-law rules relating to ordinary income treatment of amounts attributable to unrealized receivables and inventory items on sale or exchange of a partnership interest (sec. 751(a)), an investment services partnership interest is treated as an inventory item

of the partnership. Thus, for example, upon the sale or exchange of an interest in a partnership that in turn holds an investment services partnership interest, amounts received by the transferor partner that are attributable to the investment services partnership interest are considered as ordinary income.

### **Other entities**

The provision also recharacterizes as ordinary income for the performance of services the income or gain with respect to certain other interests that are held by a person who performs, directly or indirectly, investment management services for the entity.

This rule applies if (1) a person performs (directly or indirectly) investment management services for any entity, (2) the person holds a disqualified interest with respect to the entity, and (3) the value of the interest (or payments thereunder) is substantially related to the amount of realized or unrealized income or gain from the assets with respect to which the investment management services are performed. In this case, any income or gain with respect to the interest is treated as ordinary income for the performance of services. Rules similar to the exception for a partner's invested capital apply for this purpose. For this purpose, a disqualified interest in an entity means (1) any interest other than debt, (2) convertible or contingent debt, (3) an option or other right to acquire either of the foregoing, or (4) a derivative instrument entered into (directly or indirectly) with the entity or an investor in the entity. A disqualified interest does not include a partnership interest. A disqualified interest also does not include stock in a taxable corporation, which for this purpose means either a domestic C corporation or a foreign corporation that is subject to a comprehensive foreign income tax. Under this rule, a comprehensive income tax has the meaning set forth in section 457A(d)(4): the income tax of a foreign country if the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between that country and the U.S., or if the corporation demonstrates to the satisfaction of the Treasury Secretary that the foreign country has a comprehensive income tax.

For example, if a hedge fund manager holds stock of a Cayman Islands corporation that in turn is a partner in a hedge fund partnership, the manager performs investment management services for the hedge fund, and the value of the stock (or dividends) is substantially related to the growth and income in hedge fund assets for which the manager provides investment management services, then gain in the value of the stock, and dividends, are treated as ordinary income for the performance of services. The fact that the services are performed for the hedge fund, rather than directly for the Cayman Islands corporation in which the manager has a disqualified interest, does not change this result under the provision. Thus, the gain is not eligible for the capital gain tax rate, the dividend is not eligible for the special rate on qualified dividends, but rather, are subject to tax at ordinary rates as income from the performance of services. The income is treated as net earnings from self-employment for purposes of the self-employment tax of the individual who performs the services. Though the amounts received may exceed the cap (imposed by reason of section 1402(b)) on the old-age, survivors, and disability insurance portion of the self-employment tax, the hospital insurance portion of the self-employment tax is not capped, and applies to the income.

### **Underpayment penalty**

The provision provides that the accuracy-related penalty under section 6662 on underpayments applies to underpayments attributable the failure to comply with section 710(d) (relating to the treatment of income in connection with investment management services unrelated to partnership interests) or the regulations under section 710 preventing the avoidance of the purposes of section 710. The penalty rate is 40 percent. The present-law reasonable cause exception of section 6664 does not apply with respect to these underpayments, resulting in an automatic penalty.

### **Self-employment tax treatment**

Under the provision, net income from an investment services partnership interest is subject to self-employment tax. Net income from an investment services partnership interest is derived from the performance by a person of a substantial quantity of services to the partnership in the course of the active conduct of a trade or business. This income falls within the definition of net earnings from self-employment, which generally includes a partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (sec. 1402(a)), with certain exclusions. Because net income from an investment services partnership is treated as ordinary income for the performance of services, the present-law exception for gain or loss from the sale or exchange of a capital asset does not apply, even though the net income from the investment service partnership interest might otherwise be characterized as capital gain. The provision also provides that, in the case of a limited partner, the present-law exclusion for limited partners does not apply to any income treated as ordinary income from an investment services partnership interest that is received by an individual who provides a substantial quantity of the specified services.

### **Rules relating to REITs and publicly traded partnerships**

In the case of a REIT to which income and asset limitations apply under present law (sec. 856(c)(2), (3) and (4)), these income and asset tests are applied without regard to the provision. Thus, a REIT may continue to satisfy the income and asset limitations without regard to the provision.

Under the provision, a publicly traded partnership, more than 10 percent of whose gross income consists of net income from an investment services partnership interest, generally is treated as a corporation for Federal tax purposes under section 7704. The present-law exception to corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income within the meaning of section 7704(c)(2), does not apply, because net income from an investment services partnership interest is not qualifying income within the meaning of section 7704(c)(2).

The provision provides a special rule for certain partnerships that are owned by publicly traded REITs and that meet specific requirements, however. Under the special rule, the recharacterization of partnership income as ordinary income for the performance of services does not apply, provided the following requirements are met. The requirements are: (1) the partnership is treated as publicly traded (under section 7704) solely because interests in the

partnership are convertible into interests in a publicly traded REIT; (2) 50 percent or more of the capital and profits interests of the partnership are owned, directly or indirectly, at all times during the taxable year, by the REIT (taking into account attribution rules under section 267(c)); and (3) the partnership itself satisfies the REIT income and asset limitations (secs. 856(c)(2), (3), and (4), applied without regard to this provision). Thus, for example, this special rule provides that a partnership is not treated as a corporation under section 7704, in an “upreit” structure in which a publicly traded REIT owns more than 50 percent of the capital and profits interests of the partnership, partnership interests held by persons other than the REIT are convertible into publicly traded REIT stock, and the partnership itself meets the income and asset limitations of the REIT rules (secs. 856(c)(2), (3) and (4)). For this purpose, if the partnership interest may be put to the REIT or the partnership for REIT stock, it is considered convertible into interests of the publicly traded REIT. It is not intended that convertibility of partnership interests into a class of publicly traded REIT stock that tracks the performance of particular partnership assets (such as assets of a type that, if held in excess, would cause the REIT asset or income limitations not to be satisfied), or performance of the partnership assets generally, satisfies this special rule; rather, it is intended that such a partnership does not meet the requirements of this special rule.

### **Regulatory authority**

Regulatory authority is provided to prevent the avoidance of the purposes of the provision. Regulatory authority is also provided to coordinate the provision with other rules of subchapter K of the Code (relating to partnerships).

### **Effective Date**

The provision is effective generally for taxable years ending after November 1, 2007.

In the case of a partnership taxable year that includes that date, the amount of net income of a partner that is recharacterized as ordinary income for the performance of services under the provision is limited to the lesser of (1) net income for the entire partnership taxable year, or (2) net income determined by taking into account only items attributable to the part of the taxable year after that date.

The provision is effective for dispositions of partnership interests, and partnership distributions, after that date.

The provision relating to income or gain with respect to interests in certain entities other than partnerships that are held by a person who performs, directly or indirectly, investment management services for the entity takes effect on November 1, 2007.

For purposes of applying the rules relating to publicly traded partnerships (section 7704), the provision applies to taxable years beginning after December 31, 2008.

**C. Provide that Certain Indebtedness Incurred by a Partnership in Acquiring  
Qualified Securities or Commodities is Not Treated  
as Acquisition Indebtedness for Purposes of the  
Unrelated Debt-Financed Income Rules**

**Present Law**

**Unrelated business income tax**

In general, an organization that otherwise is exempt from Federal income tax is taxed on income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes.<sup>182</sup> Most exempt organizations are subject to the unrelated business income tax.<sup>183</sup>

Certain types of income are specifically exempt from the unrelated business income tax. These items include, among others, dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.<sup>184</sup> Organizations liable for tax on unrelated business taxable income ("UBTI") may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds UBTI-producing property. An exempt organization's share of partnership income that is derived from the property generally is taxed as UBTI unless an exception provides otherwise.<sup>185</sup>

**Debt-financed property**

**In general**

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Special rules apply in the case of an exempt organization that owns an interest in a partnership (or a pass-through entity taxed as a partnership) that holds debt-financed property.<sup>186</sup> In general, in such cases, if the partnership incurs acquisition indebtedness

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<sup>182</sup> Secs. 511-514.

<sup>183</sup> Organizations subject to the unrelated business income tax include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2).

<sup>184</sup> Sec. 512(b).

<sup>185</sup> Sec. 512(c).

<sup>186</sup> Sec. 512(c).

with respect to property that, if held directly by the exempt organization, would not qualify for an exception from the debt-financed property rules, the receipt of income by the exempt organization with respect to such property may result in recognition of unrelated debt-finance income.

Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.<sup>187</sup> Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by a qualified organization to acquire or improve real property (the "real property exception").<sup>188</sup>

#### Exception for debt-financed real property investments by qualified organizations

For purposes of the real property exception, a qualified organization is: (1) an educational organization described in section 170(b)(1)(A)(ii)<sup>189</sup> and its affiliated supporting organizations; (2) a qualified trust described in section 401(a) (hereinafter "pension funds"); (3) a title holding company described in section 501(c)(25) (insofar as it holds shares of organizations described in (1) or (2)<sup>190</sup>); or (4) a retirement income account described in section 403(b)(9).<sup>191</sup> To qualify for the real property exception, an acquisition or improvement by the qualified organization must meet several requirements. These include: (1) a requirement generally that the price of the property is a fixed amount determined as of the date of the acquisition or completion of the improvement; (2) restrictions against payment of the indebtedness of the arrangement being dependent upon the revenue, income, or profits derived from the property; (3) restrictions concerning sale-leaseback arrangements; and (4) in general, a prohibition against seller financing.<sup>192</sup>

Additional requirements must be met for the real property exception to apply where the real property is held by a partnership in which a qualified organization is a partner. To qualify

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<sup>187</sup> Sec. 514(c)(1).

<sup>188</sup> Sec. 514(c).

<sup>189</sup> This Code section generally describes an educational organization that operates as a school (i.e., "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on").

<sup>190</sup> Sec. 514(c)(9)(C) & (F).

<sup>191</sup> Sec. 514(c)(9)(C).

<sup>192</sup> Sec. 514(c)(9)(B)(i)-(v).

for the real property exception, the partnership must meet all of the above-described general requirements and must meet one of the following three requirements: (1) all of the partners of the partnership are qualified organizations; (2) each allocation to a partner of the partnership which is a qualified organization is a qualified allocation (within the meaning of section 168(h)(6)); or (3) the partnership satisfies a rule prohibiting disproportionate allocations.<sup>193</sup>

The disproportionate allocation rule requires two things: first, that the organization satisfy what commonly is referred to as the “fractions rule,” and second, that each allocation with respect to the partnership have substantial economic effect within the meaning of section 704(b)(2).<sup>194</sup> Under the fractions rule, the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of overall partnership loss for the taxable year for which such partner's loss share will be the smallest.<sup>195</sup> A partnership generally must satisfy the fractions rule on an actual basis and on a prospective basis for each taxable year of the partnership in which it holds debt-financed property and has at least one partner that is a qualified organization.<sup>196</sup> The fractions rule generally is intended to prevent the shifting of disproportionate income or gains to tax-exempt partners of the partnership or the shifting of disproportionate deductions, losses, or credits to taxable partners.

### **Description of Proposal**

In the case of an organization that is a partner with limited liability with respect to a partnership, the proposal provides that indebtedness incurred or continued by such partnership in purchasing or carrying any qualified security or commodity is not treated as acquisition indebtedness for purposes of the debt-financed property rules. The term qualified security or commodity means: (1) any security (as defined in section 475(c)(2), with the exception of certain contracts to which section 1256 applies);<sup>197</sup> (2) any commodity (as defined in section 475(e)(2));<sup>198</sup> or (3) any option or derivative contract with respect to a security or commodity

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<sup>193</sup> Sec. 514(c)(9)(B)(vi) & (E).

<sup>194</sup> Sec. 514(c)(9)(E)(i).

<sup>195</sup> Sec. 514(c)(9)(E)(i)(I).

<sup>196</sup> Treas. Reg. sec. 1.514(c)-2(b)(2)(i).

<sup>197</sup> This generally includes any (1) share of stock in a corporation; (2) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) note, bond, debenture, or other evidence of indebtedness; (4) interest rate, currency, or equity notional principal contract; (5) evidence of an interest in, or a derivative financial instrument in any security described in (1), (2), (3) or (4), or any currency, including any option, forward contract, short position, and any similar financial instrument in such security or currency; or (6) certain hedges with respect to a security.

<sup>198</sup> This generally includes (1) any commodity which is actively traded; (2) any notional principal contract with respect to a commodity described in (1); (3) any evidence of an interest in, or a derivative instrument in, any commodity described in (1) or (2), including any option, forward contract, futures

described in (1) or (2). Similar rules apply in the case of tiered partnerships and other flow-through entities. It is intended that, for purposes of the proposal, an organization is treated as a partner with limited liability if its share of the liabilities of the partnership is no greater than the amount of its capital in the partnership.

The proposal authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations to prevent abuse of the proposal.

#### **Effective Date**

The proposal is effective for taxable years beginning after the date of enactment.

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contract, short position, and any similar instrument in such a commodity; and (4) certain hedges with respect to a commodity.

## D. Application of Section 1239 to Partnership Interests and Tax-Sharing Agreements

### Present Law

If property is sold or exchanged between related persons, directly or indirectly, the transferor's gain is treated as ordinary income if the property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation.<sup>199</sup> Such property includes property subject to the allowance for amortization of intangibles under section 197.<sup>200</sup>

The definition of related persons for this purpose includes persons that are related under a 50-percent value test, using specified constructive ownership attribution rules.<sup>201</sup>

In some situations, taxpayers have transferred amortizable intangibles or other depreciable property to a transferee that may not be within the definition of a related party under section 1239, but in connection with the transfer the parties have contractually agreed, under a tax-sharing arrangement, that the transferor is entitled to a percentage of the tax benefits of depreciation or amortization in the hands of the transferee.

If a partner transfers an interest in a partnership, the amount of money, or the fair market value of property, received by the transferor partner in exchange for all or a part of his interest in the partnership attributable to unrealized receivables or inventory items of the partnership is considered an amount realized from the sale or exchange of property other than a capital asset. Section 751(d) defines inventory items for this purpose to include any property which, on sale or exchange by the partnership, would be considered property other than a capital asset (and other than property described in section 1231),<sup>202</sup> and also any other property held by the partnership which, if held by the selling partner would be considered property other than such property. Section 64 provides that any gain from the sale or exchange of property which is "treated or considered as 'ordinary income'" is treated as "gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)."<sup>203</sup> If a partner transfers a partnership interest to a related party within the meaning of section 1239 and the partnership owns depreciable property, taxpayers might take the position that the application of section 64

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<sup>199</sup> Sec. 1239.

<sup>200</sup> Sec. 197(f)(7).

<sup>201</sup> Sec. 1239(b).

<sup>202</sup> Property described in section 1231 is, generally, property used in the trade or business subject to the allowance for depreciation and held for more than one year. Sec.1231(b). Certain other property is also included.

<sup>203</sup> Sec. 64.

and section 1239 to section 751 is unclear, or that the depreciable property was not transferred “directly or indirectly” to the related party within the meaning of section 1239.<sup>204</sup>

### **Description of Proposal**

Under the provision, regardless of whether any other relationship exists between the transferor and transferee, a transferor is related to a transferee for purposes of section 1239 if there is a tax sharing agreement with respect to any sale or exchange. A tax sharing agreement for this purpose means any agreement that provides for the payment to the transferor of any amount that is determined by reference to any portion of the tax benefit realized by the transferee with respect to the depreciation (or amortization) of the property directly or indirectly transferred.<sup>205</sup>

Under the provision, gain recognized by the transferor of a partnership interest to a related party under section 1239 is treated as ordinary income to the extent attributable to unrealized appreciation in property which is of a character subject to depreciation. As under present law, such property includes intangible property which is of a character subject to amortization under section 197.

In the case of a transfer of a partnership interest, the provision applies with respect to any agreement with respect to depreciation or amortization realized with respect to property transferred directly or indirectly in connection with the transfer of the partnership interest. As one example, if a transferor transfers an interest in a partnership, and is entitled to receive the benefits of any tax sharing agreement with respect to property held directly or indirectly by that partnership, then the transferor's gain on transfer of the partnership interest is ordinary income to the extent attributable to such property.

No inference is intended as to the treatment under present law of any transfer subject to the provision.

### **Effective Date**

The provision is effective with respect to sales or exchanges after the date of enactment. However, the provision shall not apply to any sale or exchange pursuant to a written binding contract which includes a tax sharing agreement and which is in effect on November 1, 2007 and not modified thereafter in any material respect.

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<sup>204</sup> See, e.g., McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, (Fourth Ed. 2007) at par. 17.04[2] (see n. 138) and at par. 18.02[4] (see n. 36).

<sup>205</sup> The provision is not intended to apply to an outright sale of assets between otherwise unrelated parties in which the fixed sales price is negotiated to be higher because of the anticipated tax benefits that will be enjoyed by the transferee. However, in such a situation, if there is also a tax sharing agreement that returns to the transferor any portion of the benefits of depreciation or amortization realized by the transferee, notwithstanding the basic form of the transaction as a transfer of all the benefits to the transferee, then the parties will be treated as related for purposes of the provision.

## **E. Delay Implementation of Worldwide Interest Allocation**

### **Present Law**

#### **In general**

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.<sup>206</sup> For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called “one-taxpayer rule”) and allocation must be made on the basis of assets rather than gross income. The term “affiliated group” in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.

For consolidation purposes, the term “affiliated group” means one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

Generally, the term “includible corporation” means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.<sup>207</sup> For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same

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<sup>206</sup> However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

<sup>207</sup> One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

### Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as “financial corporations” (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity that is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

### Worldwide interest allocation

#### In general

The American Jobs Creation Act of 2004 (“AJCA”)<sup>208</sup> modified the interest expense allocation rules described above (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election (the “worldwide affiliated group election”) under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group’s worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,<sup>209</sup> over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the

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<sup>208</sup> Pub. L. No. 108-357, sec. 401 (2004).

<sup>209</sup> For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account.

principles of worldwide interest allocation were applied separately to the foreign members of the group.<sup>210</sup>

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,<sup>211</sup> would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group, as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

#### Financial institution group election

Taxpayers are allowed to apply the bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The rules also provides a one-time “financial institution group” election that expands the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the bank group, and (2) all “financial corporations.” For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.<sup>212</sup> For these purposes, items of income or gain from a transaction or series of

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<sup>210</sup> Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

<sup>211</sup> Indirect ownership is determined under the rules of section 958(a)(2) or through applying rules similar to those of section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

<sup>212</sup> See Treas. Reg. sec. 1.904-4(e)(2).

transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, anti-abuse rules are provided under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. Regulatory authority is provided with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of these rules, to prevent assets or interest expense from being taken into account more than once, or to address changes in members of any group (through acquisitions or otherwise) treated as affiliated under these rules.

#### Effective date of worldwide interest allocation under AJCA

The worldwide interest allocation rules are effective for taxable years beginning after December 31, 2008.

#### **Description of Proposal**

The proposal delays by eight years the implementation of the worldwide interest allocation rules added by AJCA. Thus, the worldwide interest allocation rules are effective for taxable years beginning after December 31, 2016.

#### **Effective Date**

The proposal is effective on the date of enactment.

## F. Broker Reporting of Customer's Basis in Securities Transactions

### Present Law

#### In general

Gain or loss generally is recognized for Federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.<sup>213</sup>

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.<sup>214</sup> The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

#### Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").<sup>215</sup> If a taxpayer makes an adequate identification of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.<sup>216</sup> A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations.<sup>217</sup>

#### Information reporting

Present law imposes information reporting requirements on participants in certain transactions. Under these requirements, information is generally reported to the IRS and furnished to taxpayers. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether taxpayers' tax returns are correct and

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<sup>213</sup> Sec. 1001.

<sup>214</sup> Sec. 1016.

<sup>215</sup> Treas. Reg. sec. 1.1012-1(c)(1).

<sup>216</sup> Treas. Reg. sec. 1.1012-1(c).

<sup>217</sup> Treas. Reg. sec. 1.1012-1(e).

complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of \$600 or more made in the course of the payor's trade or business.<sup>218</sup>

Section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sale transactions. The Secretary is authorized to require brokers to report additional information related to customers.<sup>219</sup> Brokers are required to furnish to every customer information statements with the same gross proceeds information that is included in the returns filed with the IRS for that customer.<sup>220</sup> These information statements are required to be furnished by January 31 of the year following the calendar year for which the return under section 6045(a) is required to be filed.<sup>221</sup>

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of \$50 for each return with respect to which such a failure occurs, up to a maximum of \$250,000 in any calendar year.<sup>222</sup> Similar penalties, with a \$100,000 calendar year maximum, apply to failures to furnish correct information statements to recipients of payments for which information reporting is required.<sup>223</sup>

Present law does not require information reporting with respect to a taxpayer's basis in property but does impose an obligation to keep records, as described below.

### **Basis recordkeeping requirements**

Taxpayers are required to "keep such records . . . as the Secretary may from time to time prescribe."<sup>224</sup> Treasury regulations impose recordkeeping requirements on any person required to file information returns.<sup>225</sup>

Treasury regulations provide that donors and donees should keep records that are relevant in determining a donee's basis in property.<sup>226</sup> IRS Publication 552 states that a taxpayer should

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<sup>218</sup> Sec. 6041(a).

<sup>219</sup> Sec. 6045(a).

<sup>220</sup> Sec. 6045(b).

<sup>221</sup> Id.

<sup>222</sup> Sec. 6721.

<sup>223</sup> Sec. 6722.

<sup>224</sup> Sec. 6001.

<sup>225</sup> Treas. Reg. sec. 1.6001-1(a).

<sup>226</sup> Treas. Reg. sec. 1.1015-1(g).

keep basis records for property until the period of limitations expires for the year in which the taxpayer disposes of the property.

## **Description of Proposal**

### **In general**

Under the proposal, every broker that is required to file a return under section 6045(a) reporting the gross proceeds from the sale of a covered security must include in the return the (1) customer's adjusted basis in the security and (2) whether any gain or loss with respect to the security is long-term or short-term (within the meaning of section 1222).

### **Covered securities**

A covered security is any specified security acquired on or after an applicable date if the security was (1) acquired through a transaction in the account in which the security is held or (2) was transferred to that account from an account in which the security was a covered security, but only if the transferee broker received a statement under section 6045A (described below) with respect to the transfer. Under this rule, securities acquired by gift or inheritance are not covered securities.

A specified security is any share of stock in a corporation (including stock of a regulated investment company); any note, bond, debenture, or other evidence of indebtedness; any commodity or a contract or a derivative with respect to the commodity if the Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate.

For stock in a corporation (including in a regulated investment company), the applicable date generally is January 1, 2009. Open-end funds are permitted to elect to treat as a covered security any stock in the fund acquired before January 1, 2009. This election is described below.

For any specified security other than stock in a corporation, the applicable date is January 1, 2011 or a later date determined by the Secretary.

### **Computation of adjusted basis**

The customer's adjusted basis required to be reported to the IRS is determined under the following rules. The adjusted basis of stock in a corporation other than an open-end fund is determined under the first-in, first-out method (described in Treasury regulations under section 1012) unless the customer notifies the broker by means of making an adequate identification (under the rules of section 1012 for specific identification) of the stock sold or transferred. The adjusted basis of stock in an open-end fund acquired before January 1, 2011 is determined in accordance with any permitted method under section 1012 (that is, the first-in, first-out method, the average cost method, or the specific identification method). A broker's basis computation method used for open-end stock held in one account with that broker may differ from the basis computation method used for open-end stock held in another account with that broker. The adjusted basis of stock in an open-end fund acquired on or after January 1, 2011 is determined in accordance with the broker's default method (under section 1012) unless the customer notifies

the broker that the customer elects another method permitted by section 1012. This notification is made separately for each account in which open-end stock is held and, once made, applies to all open-end stock held in the account. The adjusted basis of any covered security other than stock is determined under the applicable rules provided in section 1012.

An open-end fund is a regulated investment company that offers for sale or has outstanding any redeemable security of which it is the issuer and the shares of which are not traded on an established securities exchange. A mutual fund the stock of which is priced daily and is acquired from the fund is an open-end fund. So-called exchange traded funds, funds in which there is intra-day pricing and in which shares may be purchased on an exchange (rather than from the funds directly) are not open-end funds.

For any sale, exchange, or other disposition of a specified security after the applicable date (defined previously), the proposal modifies section 1012 so that the conventions prescribed by regulations under that section for determining adjusted basis (the first-in, first-out, specific identification, and average cost conventions) apply on an account-by-account basis. Under this rule, for example, if a customer holds shares of the same specified security in accounts with different brokers, each broker makes its adjusted basis determinations by reference only to the shares held in the account with that broker. Unless the election described next applies, stock in an open-end fund acquired before January 1, 2009 is treated as a separate account. A consequence of this rule is that if adjusted basis is being determined using the average cost convention, average cost is computed without regard to any open-end stock acquired before January 1, 2009. An open-end fund, however, may elect (at the time and in the form and manner prescribed by the Secretary), on a stockholder-by-stockholder basis, to treat as covered securities all stock in the fund held by the stockholder without regard to when the stock was acquired. When this election applies, the average cost of a customer's open-end stock is determined by taking into account shares of stock acquired before, on, and after January 1, 2009.

### **Exception for wash sales**

Unless the Secretary provides otherwise, customer's adjusted basis in a covered security generally is determined without taking into account the effect on basis of the wash sale rules of section 1091. If, however, the acquisition and sale transactions resulting in a wash sale under section 1091 occur in the same account and are in identical securities, adjusted basis is determined by taking into account the effect of the wash sale rules. Securities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures (CUSIP) number.

### **Reporting requirements for options**

The proposal generally eliminates the present-law regulatory exception from section 6045(a) reporting for certain options. If a covered security is acquired by the exercise of an option and the option was acquired in the same account as the covered security, the amount of the premium received or paid for the option is treated as an adjustment to the gross proceeds from the subsequent sale of the covered security or as an adjustment to the customer's adjusted basis in that security. Gross proceeds and basis reporting also generally is required when there is a lapse of, or a closing transaction with respect to, an option on a covered security. These

reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2011.

### **Time for providing statements to customers**

The proposal changes to February 15 the present-law January 31 deadline for furnishing certain information statements to customers. The statements to which the new February 15 deadline applies are (1) statements showing gross proceeds (under section 6045(b)) or substitute payments (under section 6045(d)) and (2) consolidated reporting statements (as defined in regulations) for reporting gross proceeds, dividends (under section 6042(c)), interest (under section 6049(c)(2)(A)), or royalties (under section 6050N(b)). The term “consolidated reporting statement” is intended to refer to annual tax information statements that brokerage firms customarily provide to their customers.

### **Broker-to-broker and issuer reporting**

Every broker (as defined in section 6045(c)(1)), and any other person specified in Treasury regulations, that transfers to a broker (as defined in section 6045(c)(1)) a security that is a covered security when held by that broker or other person must, under new section 6045A, furnish to the transferee broker a written statement that allows the transferee broker to satisfy the proposal’s basis and holding period reporting requirements. The Secretary may provide regulations that prescribe the content of this statement and the manner in which it must be furnished. It is contemplated that the Secretary will permit statements to be provided electronically. The statement required by this rule must be furnished within 45 days after the transfer of the covered security or, if earlier, by January 15 of the year in which the transfer occurred.

Present law penalties for failure to furnish correct payee statements apply to failures to furnish correct statements in connection with the transfer of covered securities.

New section 6045B requires, according to forms or regulations prescribed by the Secretary, any issuer of a specified security to file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary. This return must be filed within 45 days after the date of the organizational action or, if earlier, by January 31 of the year following the calendar year during which the action occurred. Every person required to file this return for a specified security also must furnish, according to forms or regulations prescribed by the Secretary, to the nominee with respect to that security (or to a certificate holder if there is no nominee) a written statement showing the name, address, and phone number of the information contact of the person required to file the return, the information required to be included on the return with respect to the security, and any other information required by the Secretary. This statement must be furnished to the nominee or certificate holder on or before January 31 of the year following the calendar year in which the organizational action took place. No return or information statement is required to be provided under new section 6045B for any action with respect to a specified security if the action occurs before the applicable date (as defined previously) for that security.

The Secretary may waive the return filing and information statement requirements if the person to which the requirements apply makes publicly available, in the form and manner determined by the Secretary, the name, address, phone number, and email address of the information contact of that person, and the information about the organizational action and its effect on basis otherwise required to be included in the return.

The present-law penalties for failure to file correct information returns apply to failures to file correct returns in connection with organizational actions. Similarly, the present-law penalties for failure to furnish correct payee statements apply to a failure under new section 6045B to furnish correct statements to nominees or holders or to provide required publicly-available information in lieu of returns and written statements.

### **Effective Date**

The proposal takes effect on January 1, 2009.

## **G. Modifications to Corporate Estimated Tax Payments**

### **Present Law**

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Under present law, in the case of a corporation with assets of at least \$1 billion, the payments due in July, August, and September, 2012, shall be increased to 115 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

### **Description of Proposal**

The proposal increases the percentage from 115 percent to 178 percent.

### **Effective Date**

The proposal is effective on the date of enactment.