DESCRIPTION OF H.R. 4849, THE “SMALL BUSINESS AND INFRASTRUCTURE JOBS TAX ACT OF 2010”

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on March 17, 2010. This document[1] provides a description of present law and the proposals contained in H.R. 4849, the "Small Business and Infrastructure Jobs Tax Act of 2010."

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 4849, the "Small Business and Infrastructure Jobs Tax Act of 2010,*" (JCX-13-10), March 16, 2010. This document can also be found on our website at www.jct.gov.

I. SMALL BUSINESS TAX INCENTIVES

A. General Provisions

1. Temporary exclusion of 100 percent of gain on certain small business stock

Present Law

In general

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

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

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

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[2] Sec. 1202.

[3] Sec. 1(h).

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

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

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

Temporary increase in exclusion

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

Description of Proposal

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

Effective Date

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

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

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

B. Limitations and Reporting on Certain Penalties

1. Limitation on penalty for failure to disclose certain information

Present Law

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

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[9] A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[10] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[11]

Transactions falling under the first and last categories of reportable transactions are transactions that are described in publications issued by the Treasury Department and identified as one of these types of transaction. A listed transaction is defined as a reportable transaction which is the same as, or substantially similar[12] to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[13] A "transaction of interest" is one that is the same or substantially similar to a transaction identified by the Secretary as one about which the Secretary is concerned but does not yet have sufficient knowledge to determine that the transaction is abusive.[14]

The other categories of reportable transactions are not specifically identified in published guidance, but are defined as classes of transactions sharing certain characteristics. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if an advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax

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

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

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

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

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

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

treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).[15] A transaction involves contractual protection if (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[16] A reportable loss transaction generally includes any transaction that results in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[17] Treasury has announced its intention to add a sixth category of reportable transactions, patented transactions, but has not yet done so.[18]

Section 6707A imposes a penalty for failure to comply with the reporting requirements of 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under section 6011 by both the partnership and its partners.[19] The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is $100,000 for natural persons and $200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is $10,000 for natural persons and $50,000 for all other persons.

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods specified by the Secretary. Disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[20] However, the taxpayer is only required to report the penalty one time. A public entity that is subject to a gross valuation misstatement penalty under section 6662(h) attributable

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

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

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

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

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

[20] Sec. 6707A(e).

to a non-disclosed listed transaction or non-disclosed reportable avoidance transaction may also be required to make disclosures in its SEC filings.[21]

For reportable transactions other than listed transactions, the IRS Commissioner or his delegate can rescind (or abate) the penalty only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.[22] The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. Determinations by the Commissioner regarding rescission are not subject judicial review.[23] The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission. The section 6707A penalty cannot be waived with respect to a listed transaction.

The section 6707A penalty is assessed in addition to any accuracy-related penalties. If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable cause exception to the accuracy-related penalty is not available, and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[24] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[25] The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[26]

Description of Proposal

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

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

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

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

[24] Sec. 6662A(c).

[25] Sec. 6664(d).

[26] Sec. 6707A(d).

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

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

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

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

Effective Date

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

2. Annual reports on penalties and certain other enforcement actions

Present Law

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

Reporting obligations

These disclosure requirements[27] create interlocking disclosure obligations for both taxpayers and advisors. A taxpayer is required to disclose with its tax return certain information with respect to each "reportable transaction," as defined in regulations.[28] Each advisor who provides material advice with respect to any reportable transaction (including any listed transaction) is required to file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[29] Finally, the advisor is required to maintain a list of those persons he has advised with respect to a reportable transaction and to provide the list to the IRS upon request.[30]

A reportable transaction is defined as one that the Treasury Secretary requires to be disclosed based on its potential for tax avoidance or evasion.[31] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[32]

Penalties and other enforcement tools related to reportable transactions

Each of the disclosure statutes has a parallel penalty provision to aid enforcement. The taxpayer who participates in a reportable transaction and fails to disclose it is subject to a strict liability penalty.[33] The penalty is assessed in addition to any accuracy-related penalties. It may be rescinded with respect to reportable transactions other than listed transactions. Rescission is

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[27] Secs. 6011, 6111 and 6112.

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

[29] Sec. 6111.

[30] Sec. 6112.

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

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

[33] Section 6707A imposes a penalty for failure to comply with the reporting requirements of 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under section 6011 by both the partnership and its partners.[33] The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is $100,000 for natural persons and $200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is $10,000 for natural persons and $50,000 for all other persons. A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods specified by the Secretary. Failure to comply with this reporting requirement may result in assessment of a second tier penalty.

discretionary and conditioned upon a determination by the Commissioner that rescinding the penalty would promote compliance and effective tax administration.[34] The Code also imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction). It may be rescinded, subject to limitations similar to those applicable to rescission of the penalty imposed on investors.[35] The IS may also submit a written request that a material advisor make available the list required to be maintained under section 6612(a). A failure to make the list available upon written request is subject to a penalty of $10,000 per day for as long as the failure continues, unless the advisor can establish reasonable cause for the failure.[36]

In addition to the penalties that specifically address the failure to comply with the disclosure and reporting obligations, other special enforcement provisions are applicable to reportable transactions. An understatement arising from any listed transactions or from a reportable transaction for which a significant purpose is avoidance or evasion of federal income tax will be subject to an accuracy-related penalty,[37] unless the taxpayer can establish that the failure was due to reasonable cause as determined under a standard that is more stringent than that applicable to other accuracy-related penalties.[38]

If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable cause exception is not available and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[39] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[40] Finally, a new exception to the statute of limitations provides that the period is suspended if a listed transaction is not properly disclosed.[41] If the transaction is disclosed either because the taxpayer files the proper disclosure form or a material advisor identifies the

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

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

[36] Sec. 6708.

[37] Sec. 6662A.

[38] Sec. 6664(d).

[39] Sec. 6662A(c).

[40] Sec. 6664(d).

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

The Code authorizes civil actions to enjoin any person from specified conduct relating to tax shelters or reportable transactions.[42] The specified conduct includes failure to comply with respect to the requirements relating to the reporting of reportable transactions[43] and the keeping of lists of investors by material advisors.[44] Thus, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction. In addition, injunctions, monetary penalties and suspension or disbarment are authorized with respect to violations of any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

Reports to Congress by the Secretary

The Secretary is required to maintain records and report on the administration of the penalties for failure to disclose a reportable transaction in two ways. First, each decision to rescind a penalty imposed under section 6707 or section 6707A must be memorialized in a record maintained in the Officer of the Commissioner.[45] That record must include a description of the facts and circumstances of the violation, the reasons for the decision to rescind, and the amount rescinded. Second, the IRS is required to submit an annual report to Congress on the administration of the rescission authority under both sections 6707 and 6707A. The information with respect to the latter is to be in summary form, while the information on rescission of penalties imposed against material advisors is to be more detailed.[46] The report is not required to address administration of the other enforcement tools described above.

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

[42] Sec. 7408.

[43] Sec. 6707.

[44] Sec. 6708.

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

[46] The American Jobs Creation Act provides:
”The Commissioner of Internal Revenue shall annually report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate--
”(1) a summary of the total number and aggregate amount of penalties imposed, and rescinded, under section 6707A of the Internal Revenue Code of 1986, and
”(2) a description of each penalty rescinded under section 6707(c) of such Code and the reasons therefor.”. P.L. 108-357, Title VIII, Subtitle B, Part I, § 811(d), 118 Stat. 1577, Oct. 22, 2004.

Description of Proposal

The proposal requires that the IRS, in consultation with the Secretary, submit an annual report on administration of certain penalty provisions of the Code to the House Ways and Means Committee and the Senate Committee on Finance. A summary of penalties assessed the preceding year is required. In addition, the Secretary must report actions taken against practitioners appearing before the Treasury or IRS with respect to a reportable transaction[47] and instances in which the IRS attempted to rely on the exception to the limitations period for assessment based on failure to disclose a listed transaction.[48] The penalties that are subject to this reporting requirement are those assessed in the preceding year with respect to (1) a participant's failure to disclose a reportable transaction,[49] (2) reportable transaction understatements,[50] (3) promotion of abusive shelters,[51] (4) failure of a material advisor to furnish information on a reportable transaction,[52] and (5) material advisors' failure to maintain or produce a list of reportable transactions.[53]

Effective Date

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

[47] 31 U.S.C. sec. 330(b) authorizes the Secretary to impose sanctions on those who appear before the Department, including monetary penalties and suspension or disbarment from practice before the Department.

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

[49] Sec. 6707A.

[50] Sec. 6662A.

[51] Sec. 6700.

[52] Sec. 6707.

[53] Sec. 6708.

C. Other Provisions

1. Nonrecourse small business investment company loans from the small business administration treated as amounts at risk

Present Law

Several present-law rules limit losses from business activities held by individuals, including activities held through partnerships. Under present law, the character of partnership items passes through to the partners, as if the items were realized directly by the partners. A partner's share of partnership loss is allowed only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the year in which the loss occurred.[54] The basis of a partnership interest generally includes the amount contributed by the partner to the partnership, and for this purpose, generally an increase in the partner's share of partnership liabilities (including debt) is considered as a contribution by the partner.[55]

In the case of individuals and closely held corporations, present law includes rules designed to prevent the deduction of losses exceeding the taxpayer's economic investment -- the at-risk rules[56] -- and to limit tax shelters.[57]

Present law provides an at-risk limitation on losses from an activity engaged in by the taxpayer in carrying on a trade or business or for the production of income (including through a partnership), in the case of taxpayers that are individuals or certain closely held corporations. A taxpayer is generally not considered at risk with respect to borrowed amounts if (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans), or (2) the lender has an interest (other than as a creditor) in the activity.[58] In the case of the activity of holding real property, a special rule treats qualified nonrecourse financing as an amount at risk.[59] Qualified

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[54] Sec. 704(d).

[55] Secs. 722, 752.

[56] Sec. 465.

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

[58] Sec. 465(b).

[59] In its Reasons for Change in adopting the extension of the at-risk rules to real estate and providing an exception for qualified nonrecourse financing for real estate, the Ways and Means Committee stated, "Nonrecourse financing by the seller of real property (or a person related to the seller) is not treated as an amount at risk under the bill, because there may be little or no incentive to limit the amount of such financing to the value of the property. In the case of arm's length third party commercial financing secured solely by the real property, however, the lender is

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

Description of Proposal

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

Effective Date

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

2. Increase in amount allowed as deduction for start-up expenditures

Present Law

A taxpayer can elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins.[60] However, the $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds $50,000.[61] Start-up expenditures that are not deductible in the year in which the active trade or business begins are, at the taxpayer's election, amortized over a 15-year period beginning with the month the active trade or business begins.[62] Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began.[63]

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much less likely to make loans which exceed the property's value or which cannot be serviced by the property; it is more likely that such financing will be repaid and that the purchaser consequently has or will have real equity in the activity." H. Rep. No. 99-426, Tax Reform Act of 1985, *Report of the Committee on Ways and Means, House of Representatives, on H.R. 3838*, December 7, 1985, at 293; and see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Cong., Pub. L. No. 99514)*, JCS-10-87, May 4, 1987, at 257.

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

[61] Ibid.

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

[63] Sec. 195(c).

Treasury regulations[64] provide that a taxpayer is deemed to have made an election under section 195(b) to amortize its start-up expenditures for the taxable year in which the active trade or business to which the expenditures relate begins. A taxpayer that chooses to forgo the deemed election must clearly elect to capitalize its start-up expenditures on its timely filed Federal income tax return for the taxable year the active trade or business commences. The election either to amortize or capitalize start-up expenditures is irrevocable and applies to all start-up expenditures related to the active trade or business.

Description of Proposal

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

Effective Date

The proposal applies to taxable years beginning in 2010 or 2011.

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

II. INFRASTRCTURE INCENTIVES

A. Extension of Build America Bonds

<u>Present Law</u>

<u>Build America Bonds</u>

Section 54AA, added to the Code by the American Recovery and Reinvestment Act of 2009 ("ARRA"),[65] permits an issuer to elect to have an otherwise tax-exempt bond, issued prior to January 1, 2011, treated as a "Build America Bond."[66] In general, Build America Bonds are taxable governmental bonds, the interest on which is subsidized by the Federal government by means of a tax credit to the holder ("tax-credit Build America Bonds") or, in the case of certain qualified bonds, a direct payment to the issuer ("direct-pay Build America Bonds").

<u>Definition and general requirements</u>

A Build America Bond is any obligation (other than a private activity bond) if the interest on such obligation would be (but for section 54AA) excludable from gross income under section 103,[67] and the issuer makes an irrevocable election to have the rules in section 54AA apply.[68] In determining if an obligation would be tax-exempt under section 103, the credit (or the payment discussed below for direct-pay Build America Bonds) is not treated as a Federal guarantee.[69] Further, for purposes of the restrictions on arbitrage in section 148, the yield on a tax-credit Build America Bond is determined without regard to the credit;[70] the yield on a direct-pay Build America Bond is reduced by the payment made pursuant to section 6431.[71] A Build America

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

[66] Sec. 54AA.

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

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

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

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

[71] Sec. 6431(c).

Bond does not include any bond if the issue price has more than a de minimis amount of premium over the stated principal amount of the bond.[72]

Treatment of holders of tax-credit Build America Bonds

The holder of a tax-credit Build America Bond accrues a tax credit in the amount of 35 percent of the interest paid on the interest payment dates of the bond during the calendar year.[73] The interest payment date is any date on which the holder of record of the Build America Bond is entitled to a payment of interest under such bond.[74] The sum of the accrued credits is allowed against regular and alternative minimum tax; unused credit may be carried forward to succeeding taxable years.[75] The credit, as well as the interest paid by the issuer, is included in gross income, and the credit may be stripped under rules similar to those provided in section 54A regarding qualified tax credit bonds.[76] Rules similar to those that apply for S corporations, partnerships and regulated investment companies with respect to qualified tax credit bonds also apply to the credit.[77]

Special rules for direct-pay Build America Bonds

Under the special rule for qualified bonds, in lieu of the tax credit to the holder, the issuer is allowed a credit equal to 35 percent of each interest payment made under such bond.[78] A "qualified bond," that is, a direct-pay Build America Bond, is any Build America Bond issued as part of an issue if 100 percent of the excess of available project proceeds of such issue over the amounts in a reasonably required reserve with respect to such issue are to be used for capital expenditures.[79] Direct-pay Build America Bonds may not be issued to refinance capital expenditures in "refunding issues" (as defined in Treas. Reg. sec. 1.150-1).[80] Direct-pay Build

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

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

[74] Sec. 54AA(e).

[75] Sec. 54AA(c).

[76] Sec. 54AA(f).

[77] Ibid.

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

[79] Sec. 54AA(g).

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

America Bonds also must be issued before January 1, 2011. The issuer must make an irrevocable election to have the special rule for qualified bonds apply.[81]

The payment by the Secretary is to be made contemporaneously with the interest payment made by the issuer, and may be made either in advance or as reimbursement.[82] In lieu of payment to the issuer, the payment may be made to a person making interest payments on behalf of the issuer.[83]

Description of Proposal

The proposal extends both types of Build America Bonds through June 30, 2013. For direct-pay Build America Bonds issued in 2011, the proposal provides for a payment to the issuer equal to 33 percent of each interest payment made under such bond. For direct-pay Build America Bonds issued in 2012, the rate for payments to issuers is reduced to 31 percent of each interest payment; for direct-pay Build America Bonds issued in 2013, the rate is reduced to 30 percent.

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

Effective Date

The proposal is effective as of the date of enactment.

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

[82] Sec. 6431.

[83] Sec. 6431(b).

B. Eliminate the Volume Cap for Private Activity Bonds for Water Infrastructure

Present Law

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Interest on State or local bonds issued to finance activities of private persons is taxable unless issued for certain purposes permitted by the Code ("qualified private activity bonds"). [84]

The definition of a qualified private activity bond includes exempt facility bonds, qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), and student loan bonds.[85] The definition of an exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); low-income residential rental property; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; and qualified green building/sustainable design projects.[86] A facility for the furnishing of water will qualify as an exempt facility if: the water is or will be made available to members of the general public (including electric, industrial, agricultural, or commercial users); and either the facilities are (1) operated by a governmental unit or (2) the rates for the furnishing or sale of the water have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.[87]

Issuance of most qualified private activity bonds is subject (in whole or in part) to annual State volume limitations ("State volume cap").[88] For calendar year 2010, the State volume cap, which is indexed for inflation, equals $90 per resident of the State, or $273,775,000, if greater.[89]

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

[84] Sec. 103(b)(1).

[85] Sec. 141(e).

[86] Sec. 142(a).

[87] Sec. 142(e).

[88] Sec. 146.

[89] Rev. Proc. 2009-50.

building/sustainable design projects, and qualified highway or surface freight transfer facility bonds).

If an issuing authority's State volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the authority generally may elect to treat all (or any portion) of the excess as a carryforward for one or more specified "carryforward purposes." The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean one of four purposes: issuing exempt facility bonds; issuing qualified mortgage bonds or mortgage credit certificates; issuing qualified student loan bonds; and issuing qualified redevelopment bonds.[90] A carryforward of unused State volume cap is valid for three years.

Many States have State revolving fund programs ("SRFs") to finance wastewater and drinking water projects. SRFs are pools of capital dedicated to financing public infrastructure formed through Federal and state contributions. SRFs use Federal grants to make loans to local governments to finance the construction of water facilities and to establish debt service reserve funds for bonds the proceeds of which are so be used to make such loans. Although present law generally prohibits the Federal guarantee of tax-exempt bonds,[91] the IRS has ruled that States may use Federal grants to fund debt service reserve funds for tax-exempt bonds issued to finance SRF loans without affecting the tax-exempt status of such bonds.[92]

Description of Proposal

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

Effective Date

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

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[90] Sec. 146(f)(5).

[91] Sec. 149(b).

[92] Notice 88-54, 1988-1 C.B. 539.

C. Modification of Alternative Minimum Tax Limitations on Tax-Exempt Bonds

Present Law

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

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

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

Description of Proposal

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

Effective Date

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

D. Elective Payments in Lieu of Low-Income Housing Credits for 2010

Present Law

Tax credits

In general

The low-income housing credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels.[93] The amount of the credit for any taxable year in the credit period is the "applicable percentage" of the qualified basis of each qualified low-income building. Generally, the applicable percentage is 70 percent for a new non-Federally subsidized building and 30 percent for all other buildings. Generally, a new building is considered Federally-subsidized if it also receives tax-exempt bond financing. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

Volume limits

Generally, a low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Each State has a limited amount of low-income housing credit available to allocate. This amount is called the aggregate housing credit dollar amount. The aggregate housing credit dollar amount for each State has four components: (1) the unused housing credit ceiling, if any, of such State from the prior calendar year; (2) the credit ceiling for the year; (3) any returns of credit ceiling to the State during the calendar year from previous allocations; and (4) the State's share, if any, of the national pool of unused credits from other States that failed to use them (only States which allocated their entire credit ceiling for the preceding calendar year are eligible for a share of the national pool. For calendar year 2010, each State's credit ceiling is $2.10 per resident, with a minimum annual cap of $2,430,000 for certain small population States.[94] These amounts are indexed for inflation.

Certain buildings that also receive financing with proceeds of tax-exempt bonds do not require an allocation of the low-income housing credit. Generally, these buildings are buildings where 50 percent or more of the aggregate basis of the building and the land on which the building is located is financed with obligations tax exempt under section 103 and subject to the private activity bond volume limits.[95]

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[93] Sec. 42.

[94] Rev. Proc. 2009-50.

[95] Sec. 146

Special basis rule

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

Grants in lieu of tax credits for 2009

Low-income housing grant election amount

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

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

These grants are not taxable income to recipients.

Subawards to low-income housing credit buildings

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

Any building receiving grant money from a subaward must satisfy the low-income housing credit rules. The State housing credit agency shall perform asset management functions to ensure compliance with the low-income housing credit rules and the long-term viability of buildings financed with these subawards.[96] Failure to satisfy the low-income housing credit rules will result in recapture enforced by means of liens or other methods that the Secretary (or delegate) deems appropriate. Any such recapture will be payable to the Secretary for deposit in the general fund of the Treasury.

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[96] The State housing credit agency may collect reasonable fees from subaward recipients to cover the expenses of the agency's asset management duties. Alternatively, the State housing credit agency may retain a third party to perform these asset management duties.

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

Special basis rule

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

Reduction in low-income housing credit volume limit for 2009

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

Description of Proposal

Elective payments in lieu of low-income housing credit for certain bond-financed buildings

In general

At the election of the taxpayer, a portion of the otherwise applicable low-income housing credit with respect to certain buildings equal to the "direct payment amount" is treated as a payment against Federal income tax. In this manner, the low-income housing credit otherwise available is converted to a cash equivalent. The direct payment amount with respect to such a building is 85 percent of 30 percent (i.e., 25.5 percent) of the qualified basis of such building. This election is limited only to those tax-exempt bond financed buildings which do not require an allocation of low-income housing credit.

The election does not apply with respect to any building placed in service by any government entity or tax-exempt organization. In the case of property placed in service by a partnership or S corporation, the election must be made at the entity level.

Low-income housing credit rules

Rules similar to the low-income housing credit rules (including recapture) continue to apply.

Tax treatment of amounts received

Any credit or refund allowed under this provision is not includible in the taxpayer's gross income or alternative minimum taxable income.

Termination

The provision does not apply with respect to any building placed in service during a taxable year beginning after December 31, 2010.

Effective Date

The provision relating to elective payments in lieu of low-income housing credit for certain bond-financed buildings is effective for buildings placed-in-service after the date of enactment.

E. Extension and Additional Allocations of Recovery Zone Bond Authority

Present Law

In general

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

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

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

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

Recovery zone economic development bonds

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

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

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

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

Recovery zone facility bonds

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

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

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

1. Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);

2. The restriction on acquisition of existing property does not apply (sec. 147(d));

Description of Proposal

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

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

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

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

Under present law and under the proposal, a county or municipality may waive any portion of an allocation made to it. The proposal further provides that by State law, a State may treat a county or municipality as waiving any portion of an allocation made to a county or municipality if there is a reasonable expectation that such allocation would not be used. This rule applies to all allocations, including the first round of allocations made in 2009. No negative inference is intended regarding State laws enacted prior to the date of enactment, which deem a county or municipality's allocation waived.

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

Effective Date

The proposal is effective on the date of enactment.

F. Allowance of New Markets Tax Credit Against Alternative Minimum Tax

Present Law

Under present law, business tax credits generally may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability in excess of $25,000). Credits in excess of the limitation may be carried back one year and carried over for up to 20 years.

The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

Thus, business tax credits generally cannot offset the alternative minimum tax liability.

Description of Proposal

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

Thus, the new markets tax credit may offset the alternative minimum tax liability.

Effective Date

The proposal applies to qualified equity investments (as defined in section 45D(b)) initially made after March 15, 2010, and before January 1, 2012.

III. REVENUE PROVISIONS

A. Limitation on Treaty Benefits for Certain Deductible Payments

Present Law

In general

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

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

Tax treaties

A foreign corporation may not benefit from a provision of a U.S. tax treaty with a foreign country that eliminates or reduces U.S. withholding tax unless the foreign corporation is both a resident of such foreign country and qualifies under any limitation-on-benefits provision contained in the U.S. tax treaty with such foreign country. In general, a foreign corporation is a resident of a foreign country under a U.S. tax treaty with that foreign country if it is liable to tax in that country by reason of its domicile, residence, citizenship, place of management, place of incorporation, or other criterion of a similar nature.[97]

Limitation-on-benefits provisions generally

Limitation-on-benefits provisions in income tax treaties are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents. Treaty shopping is said to occur when an entity that is resident in a country with respect to which there is no relevant tax treaty in force (or there is such a treaty in force but the taxpayer desires better benefits than those offered under that treaty) becomes resident in a treaty country or conducts a transaction in such a country for the purpose of qualifying for treaty benefits. For example, treaty shopping by a third-country resident may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency

[97] United States Model Income Tax Convention of November 15, 2006, Art. 4, par. 1.

may attempt to reduce the income base of a related treaty-country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made.

U.S. tax treaties contain a variety of limitation-on-benefits provisions due to the continued and recently accelerated development of limitation-on-benefits concepts, and the negotiated nature of tax treaties in general. Although many older U.S. tax treaties may lack limitation-on-benefits provisions[98] or lack the refinements now thought essential to such provisions, the U.S. model income tax treaty, as most recently revised in 2006 ("U.S. model treaty"),[99] and the newer U.S. treaties include limitation-on-benefits provisions that limit treaty benefits to resident taxpayers that meet certain detailed requirements intended to minimize these abuses. Present Treasury Department policy, which has been repeatedly ratified by the Senate, is broadly to revise older treaties by tightening limitation-on-benefits provisions to prevent treaty shopping.

The limitation-on-benefits rules included in U.S. income tax treaties and protocols signed since 2001 generally correspond with the limitation-on-benefits provisions of the U.S. model treaty. Certain features of the limitation-on-benefits provisions in recent treaties and protocols, however, differ from the rules in the U.S. model treaty, and some recent treaties and protocols include additional limitation-on-benefits rules not included in the U.S. model treaty. Some of the additions and differences make limitation-on-benefits provisions more restrictive than the rules in the U.S. model treaty, and others make the provisions less restrictive.

The U.S. model treaty limitation-on-benefits provision

The limitation-on-benefits rules of the U.S. model treaty include three provisions under which a resident of a treaty country may qualify for treaty benefits. First, a treaty-country resident may qualify for all treaty benefits if it has any one of several listed attributes. Second, a treaty-country resident that does not have one of the listed attributes may qualify for treaty benefits for income items that are derived from the other treaty country and that are related to a trade or business carried on in the residence country. Third, a treaty-country resident that would not be eligible for treaty benefits under either of the preceding two provisions may qualify for treaty benefits at the discretion of the competent authority of the other treaty country. These three provisions are described in more detail below.

Listed attributes qualifying a treaty-country resident for treaty benefits

A treaty-country resident may qualify for treaty benefits under the U.S. model treaty if it has one of the following attributes: it is (1) an individual; (2) a contracting state or a political subdivision or a local authority of the contracting state; (3) a company that satisfies either a

[98] U.S. income tax treaties with Greece, Hungary, Pakistan, the Philippines, Poland, and Romania are examples of such treaties, each of which entered into force more than 25 years ago. The United States recently signed a new income tax treaty with Hungary that contains a modern limitation-on-benefits provision; the U.S. Senate must still ratify that treaty before it may enter into force.

[99] United States Model Income Tax Convention of November 15, 2006, Art. 22.

public trading or ownership test described below; (4) a pension fund or other tax-exempt organization (if, in the case of a pension fund, more than 50 percent of the fund's beneficiaries, members, or participants are individuals resident in either treaty country); or (5) a person other than an individual that satisfies the ownership and base erosion test described below.

Public trading and ownership tests.—A company satisfies the public trading test if its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges and either its principal class of shares is primarily traded on one or more recognized stock exchanges located in the treaty country in which the company is a resident or the company's primary place of management and control is in its country of residence. A company may satisfy the ownership test if at least 50 percent of the aggregate vote and value of the company's shares (and at least 50 percent of any disproportionate class of the company's shares) is owned directly or indirectly by five or fewer companies entitled to benefits under the public trading test described above. This ownership test may be satisfied by indirect ownership only if each intermediate owner is a resident of either treaty country.

Ownership and base erosion test.—A resident of a treaty country satisfies the ownership prong of the ownership and base erosion test if on at least half the days of the taxable year, persons that are residents of that country and that are entitled to treaty benefits as individuals, governments, companies that satisfy the public trading test, or pension funds or other tax-exempt organizations own, directly or indirectly, stock representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the resident for whom treaty benefit eligibility is being tested. This ownership requirement may be satisfied by indirect ownership only if each intermediate owner is a resident of the country of residence of the person for which entitlement to treaty benefits is being tested. A resident of a treaty country satisfies the base erosion prong of the ownership and base erosion test if less than 50 percent of the person's gross income for the taxable year, as determined in the person's country of residence, is paid or accrued, directly or indirectly, in the form of deductible payments to persons who are not residents of either treaty country entitled to treaty benefits as individuals, governments, companies that satisfy the public trading test, or pension funds or other tax-exempt organizations (other than arm's-length payments in the ordinary course of business for services or tangible property).

Items of income derived from an active trade or business

Under the U.S. model treaty, a resident of a treaty country that is not eligible for all treaty benefits under any of the rules described above may be entitled to treaty benefits with respect to a particular item of income derived from the other treaty country. A resident is entitled to treaty benefits for such an income item if the resident is engaged in the active conduct of a trade or business in its country of residence (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer) and the income derived from the other treaty country is derived in connection with, or is incidental to, that trade or business. If a resident of a treaty country derives an item of income from a trade or business activity that it conducts in the other treaty country, or derives an income item arising in that other country from a related person, the income item eligibility rule just described is considered satisfied for that income item only if the trade or business activity carried on by the

resident in its country of residence is substantial in relation to the trade or business activity carried on by the resident or the related person in the other country. The determination whether a trade or business activity is substantial is based on all the facts and circumstances.

Discretionary grant of benefits by competent authority

A resident of a treaty country not otherwise eligible for treaty benefits under the U.S. model treaty may be eligible for the benefits of the treaty generally or eligible for the benefits with respect to a specific item of income, based on a determination by the competent authority of the other treaty country. The competent authority may grant such benefits if it determines that the establishment, acquisition, or maintenance of the person for whom treaty benefits eligibility is being tested, and the conduct of that person's operations, did not have as one of its principal purposes the obtaining of benefits under the treaty.

Description of Proposal

The proposal limits tax treaty benefits with respect to U.S. withholding tax imposed on deductible related-party payments. Under the proposal, the amount of U.S. withholding tax imposed on deductible related-party payments may not be reduced under any U.S. income tax treaty unless such withholding tax would have been reduced under a U.S. income tax treaty if the payment were made directly to the "foreign parent corporation" of the payee. A payment is a deductible related-party payment if it is made directly or indirectly by any entity to any other entity, it is allowable as a deduction for U.S. tax purposes, and both entities are members of the same "foreign controlled group of entities."

For purposes of the proposal, a foreign controlled group of entities is a "controlled group of corporations" as defined in section 1563(a)(1), modified as described below, in which the common parent company is a foreign corporation. Such common parent company is referred to as the "foreign parent corporation." A controlled group of corporations consists of a chain or chains of corporations connected through direct stock ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations. For purposes of the proposal, the relevant ownership threshold is lowered from "at least 80 percent" to "more than 50 percent," certain members of the controlled group of corporations that would otherwise be treated as excluded members are not treated as excluded members,[100] and insurance companies

[100] Under section 1563(b)(2), a corporation which is a member of a controlled group of corporations on December 31 of a taxable year is treated as an excluded member of the group for the taxable year that includes such December 31 if such corporation ─

(A) is a member of the group for less than one-half the number of days in such taxable year which precedes such December 31;

(B) is exempt from taxation under section 501(a) for such taxable year;

(C) is a foreign corporation subject to tax under section 881 for such taxable year;

(D) is an insurance company subject to taxation under section 801; or

are not treated as members of a separate controlled group of corporations. In addition, a partnership or other noncorporate entity is treated as a member of a controlled group of corporations if such entity is controlled by members of the group.

The Secretary may prescribe regulations that are necessary or appropriate to carry out the purposes of the proposal, including regulations providing for the treatment of two or more persons as members of a foreign controlled group of entities if such persons would be the common parent of such group if treated as one corporation, and regulations providing for the treatment of any member of a foreign controlled group of entities as the common parent of that group if such treatment is appropriate taking into account the economic relationships among the group entities.

For example, under the proposal, a deductible payment made by a U.S. entity to a foreign entity with a foreign parent corporation that is resident in a country with respect to which the United States does not have an income tax treaty is always subject to the statutory U.S. withholding tax rate of 30 percent, irrespective of whether the payee qualifies for benefits under a tax treaty. If, instead, the foreign parent corporation is a resident of a country with respect to which the United States does have an income tax treaty that would reduce the withholding tax rate on a payment made directly to the foreign parent corporation (regardless of the amount of such reduction), and the payment would qualify for benefits under that treaty if the payment were made directly to the foreign parent corporation, then the payee entity will continue to be eligible for the reduced withholding tax rate under the U.S. income tax treaty with the payee entity's residence country (even if such reduced treaty rate is lower than the rate that would be imposed on a hypothetical direct payment to the foreign parent corporation).

Effective Date

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

(E) is a franchised corporation (as defined in section 1563(f)(4)).

B. Treatment of Securities of a Controlled Corporation Exchanged for Assets in Certain Reorganizations

Present Law

The transfer of assets by a transferor corporation to another corporation, controlled (immediately after the transfer) by the transferor or one or more of its shareholders, will qualify as a tax-free reorganization if the transfer is made by one corporation of a part of its assets consisting of an active trade or business meeting certain requirements to a controlled subsidiary corporation, followed by the distribution of the stock and securities of the controlled subsidiary in a divisive spin-off, split-off, or split-up which was not used principally as a device for the distribution of earnings and profits ("divisive D reorganization").[101]

No gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.[102] If property other than stock or securities is received ("other property"), gain is recognized to the extent the other property is not distributed.[103]

In addition, in the case of a transfer of money or other property received in the exchange to the corporation's creditors in connection with the reorganization, gain is recognized to the extent the sum of the money and the fair market value of the other property exceeds the adjusted bases of the assets transferred (net of liabilities).[104] Such a transfer to creditors is aggregated with other assumptions of the transferor corporation's liabilities by the transferee, which generally cause gain recognition if they exceed the adjusted basis of assets transferred. [105]

For example, if in a divisive D reorganization the controlled corporation either (1) directly assumes the debt of the distributing corporation, or (2) borrows and distributes cash to the distributing corporation to pay the distributing corporation's creditors, such debt assumption or cash distribution is treated as money received by the distributing corporation, and is taxable to the extent it exceeds the distributing corporation's basis in the assets transferred to the controlled corporation. By contrast, if the controlled corporation leverages itself by issuing its debt securities to the distributing corporation, the controlled corporation's debt securities are not treated as money received by the distributing corporation. Thus, the distributing corporation

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[101] Secs. 355 and 368(a)(1)(D). Section 355 imposes other requirements to avoid gain recognition at the corporate level with respect to the spin off, split up, or split off, e.g., secs. 355(d) and (e).

[102] Sec. 361(a).

[103] Sec. 361(b).

[104] The last sentence of sec. 361(b)(3). Such a transfer to creditors is aggregated with other assumptions of the transferor corporation's liabilities by the transferee, which generally cause gain recognition if they exceed the adjusted basis of assets transferred.

[105] Sec. 357(c).

could use the controlled corporation's securities to retire the distributing corporation's own debt, recognize no gain, and be in the same economic position as if its debt had been directly assumed by the controlled corporation or as if it had retired its debt with cash received from the controlled corporation.

Description of Proposal

The proposal provides, in the case of a divisive D reorganization, no gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock other than nonqualified preferred stock (as defined in section 351(g)(2)). Thus, under the provision, securities and nonqualified preferred stock are treated as "other property."

Under the proposal, the transferor corporation's gain on the exchange is recognized to the extent of the sum of money and the value of other property, including securities and nonqualified preferred stock, not distributed in pursuance of the plan of reorganization. Also, gain on the exchange is recognized to the extent that the sum of money and the value of all property other than stock that is not nonqualified preferred stock which is transferred to creditors exceeds the adjusted bases of the assets transferred (net of liabilities).

For example, under the proposal, in a divisive D reorganization, the exchange of the controlled corporation's securities for the distributing corporation's securities would be treated in the same manner as (1) the assumption of the distributing corporation's debt by the controlled corporation or (2) the use of a cash distribution from the controlled corporation to retire debt of the distributing corporation.

Effective Date

The proposal applies to exchanges occurring after the date of enactment.

However, the proposal does not apply to any exchange in connection with a transaction which is (i) made pursuant to an agreement which was binding on March 15, 2010, and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

C. Repeal of Special Rules for Interest and Dividends Received from Persons Meeting the 80-Percent Foreign Business Requirements

Present Law

The source of interest and dividend income generally is determined by reference to the country of residence of the payor.[106] Thus, an interest or dividend payment from a U.S. payor to a foreign person generally is treated as U.S.-source income and is subject to the 30-percent gross-basis U.S. withholding tax.[107] However, if a resident alien individual ("individual") or U.S. corporation satisfies an 80-percent active foreign business income requirement (the "80/20 test"), all or a portion of any interest paid by the individual or that U.S. corporation (a so-called "80/20 company") is exempt from U.S. withholding tax. Interest paid by an individual that satisfies the 80/20 test or by an 80/20 company is treated as foreign-source income and is therefore exempt from the 30-percent withholding tax if it is paid to unrelated parties.[108] When an individual or 80/20 company pays interest to a related party, the re-sourcing rule applies only to the percentage of the interest that is equal to the percentage of the individual or 80/20 company's foreign-source income (described below) as a portion of the individual or 80/20 company's total gross income during the three-year testing period (a so-called "look-through" approach).[109]

In addition to interest, the payment of a dividend by an 80/20 company will also be exempt from U.S. withholding tax. Unlike interest, a dividend paid by an 80/20 company remains U.S. source (for example, for foreign tax credit limitation purposes). However, a percentage of the dividend paid by an 80/20 company to a foreign shareholder is exempt from the 30-percent gross-basis U.S. withholding tax. As with related-party interest, the percentage equals the percentage of the 80/20 company's total gross income during the testing period that is foreign source.[110]

In general, an individual or U.S. corporation meets the 80/20 test if at least 80 percent of the gross income of the individual or corporation during the testing period is derived from foreign sources and is attributable to the active conduct of a trade or business in a foreign country (or a U.S. possession) by the individual or corporation or, in the case of the corporation, a 50-percent owned subsidiary of that corporation. The testing period generally is the three-year period preceding the year in which the interest or dividend is paid.[111]

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[106] Secs. 861(a)(1), (2), 862(a)(1), (2).

[107] Secs. 871(a)(1)(A), 881(a)(1), 1441(b), 1442(a).

[108] Sec. 861(a)(1)(A).

[109] Sec. 861(c)(2).

[110] Sec. 871(i).

[111] Sec. 861(c)(1). The income of a subsidiary is attributed to the tested company only to the extent that the tested company actually receives income from the subsidiary in the form of dividends. *Conference Report to the*

Description of Proposal

The proposal repeals the provision that treats as foreign source all or a portion of any interest paid by a resident alien individual or U.S. corporation that meets the 80/20 test. The proposal also repeals the provision that treats all or a portion of any dividends paid by a U.S. corporation that meets the 80/20 test as being exempt from withholding tax.

The repeal of the 80/20 company provisions relating to the payment of interest shall not apply to payments of interest on obligations issued before the date of enactment unless such interest is payable to a related person (as determined under rules similar to the rules of section 954(d)(3)).[112] However, a significant modification of the terms of any obligation (including any extension of the term of such obligation) shall be treated as the issuance of a new obligation. For purposes of determining what constitutes a significant modification, it is anticipated that rules similar to those under section 1001 shall apply.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2010.

1986 Tax Reform Act, Pub. L. No. 99-514, Vol II, 602. See also Rev. Rul. 73-63, 1973-1 C.B. 336 and P.L.R. 6905161160A (May 16, 1969).

[112] A person will be treated as a related person with respect to a controlled foreign corporation if (A) such person is an individual, corporation, partnership, trust or estate which controls, or is controlled by, the controlled foreign corporation, or (B) such person is a corporation, partnership, trust or estate which is controlled by the same person or persons which control the resident controlled foreign corporation. For purposes of the preceding sentence, control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of stock of such corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests in such partnership, trust, or estate. For purposes of this paragraph, rules similar to the rules of section 958 shall apply. Sec. 954(d)(3).

D. Information Reporting for Rental Property Expense Payments

<u>Present Law</u>

A variety of information reporting requirements apply under present law.[113] These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete.

The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments to any one payee aggregating $600 or more in any taxable year in the course of that payor's trade or business.[114] Payments subject to reporting include fixed or determinable income or compensation, but do not include payments for goods or certain enumerated types of payments that are subject to other specific reporting requirements.[115] The payor is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.[116] The regulations generally except from reporting, payments to corporations, exempt organizations, governmental entities, international organizations, or retirement plans.[117] Additionally, the requirement that businesses report certain fixed or determinable payments of income or gain, by its terms, is not applicable to persons engaged in a passive investment activity.

A taxpayer whose rental real estate activity is a trade or business is subject to this reporting requirement, but a taxpayer whose rental real estate activity is not considered a trade or business is not subject to the requirement.

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[113] Secs. 6031through 6060.

[114] Sec. 6041(a). Information returns are generally submitted electronically on Forms 1096 and Forms 1099, although certain payments to beneficiaries or employees may require use of Forms W-3 and W-2, respectively. Treas. Reg. sec. 1.6041-1(a)(2).

[115] Sec. 6041(a) requires reporting as to "other fixed or determinable gains, profits, and income (other than payments to which section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a) or 6050N(a) applies and other than payments with respect to which a statement is required under authority of section 6042(a), 6044(a)(2) or 6045)[.]" The payments thus excepted include most interest, royalties, and dividendsthat are subject to other specific reporting requirements.

[116] Sec. 6041(d). Specifically, the recipient of the payment is required to provide a Form W-9 to the payor, which enables the payee to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor. If a Form W-9 is not provided, the payor is required to "backup withhold" tax at a rate of 28 percent of the gross amount of the payment unless the payee has otherwise established that the income is exempt from backup withholding. The backup withholding tax may be credited by the payee against regular income tax liability, i.e., it is effectively an advance payment of tax, similar to the withholding of tax from wages. This combination of reporting and backup withholding is designed to ensure that U.S. persons pay an appropriate amount of tax with respect to all income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

[117] Treas. Reg. sec. 1.6041-3(p). Certain for-profit health provider corporations are not covered by this general exception, including those organizations providing billing services for such companies.

Persons engaged in certain real estate transactions generally must report the gross proceeds paid from such transactions.[118] A real estate transaction is defined by regulation as a sale or exchange of reportable real estate, which in turn is defined to include present or future ownership interests, but not most leaseholds.[119]

In addition, financial institutions are required to report to both taxpayers and the IRS the amount of interest taxpayers paid during the year on mortgages they held on their rental properties.[120]

A taxpayer is subject to penalties for failure to comply with the information reporting requirements. Such penalties may include a penalty for failure to file the information return,[121] for failure to furnish payee statements,[122] or for failure to comply with other various reporting requirements.[123]

Description of Proposal

The proposal provides that recipients of rental income from real estate generally are treated as persons engaged in a trade or business for purposes of the information reporting requirements. Rental income recipients making payments of $600 or more to a service provider (such as a plumber, painter, or accountant) with respect to the rental property are required to provide an information return (typically Form 1099-MISC) to the IRS and to the service provider. However, the recipient of rental income need not report under this provision with respect to the rental income that is derived from a qualified residence.

For this purpose, a qualified residence is the principal residence of the taxpayer, and one other residence of the taxpayer, selected by the taxpayer, that meets a personal use requirement. This requirement is that the residence be used personally by the taxpayer during the calendar

[118] Sec. 6045(e) requires reporting by real estate brokers, persons responsible for closing and others designed in regulations, but excepts from reporting sales of principal residences for $250,000 or less ($500,000 for married persons).

[119] Treas. Reg. sec. 1.6045-4(b)(2) defines reportable real estate to include rights to possession or use of real estate only if such rights were created prior to January 1, 1991, and had a remaining term of at least 30 years.

[120] Sec. 6050H. This information is provided on Form 1098.

[121] Sec. 6721. The penalty for the failure to file an information return generally is $50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed $250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

[122] Sec. 6722. The penalty for failure to provide a correct payee statement is $50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed $100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

[123] Sec. 6723. The penalty for failure to timely comply with a specified information reporting requirement is $50 per failure, not to exceed $100,000 for a calendar year.

year for the greater of (1) fourteen days or (2) 10 percent of the number of days during the year for which the property is let at a fair market rental. Thus, for example, if a property is rented for a total of 90 days during the year, and the taxpayer personally uses the property for 14 days, the property is a qualified residence and expenses paid with respect to that property are not subject to reporting. If the same property had instead been rented for 300 days of the year, and the taxpayer used the property only 14 days, the property would not be a qualified residence and the reporting obligation applies. To be exempt from reporting with respect to expenses on that property, the taxpayer's personal use would have to equal or exceed 30 days.

Effective Date

The proposal applies to payments made after December 31, 2010.

E. Application of Levy to Payments to Federal Vendors Relating to Property

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property or rights to property to pay the taxpayer's tax liability.[124] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[125] and the IRS has provided both notice of intention to levy[126] and notice of the right to an administrative hearing (referred to as a collections due process notice or "CDP" notice)[127] at least 30 days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[128]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable in permitting assessment of tax without following the normal deficiency procedures.[129]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a federal tax liability from a state tax refund. In addition, a levy issued to collect federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. The taxpayer, however, in each of these three cases, is provided an opportunity for a hearing within a reasonable period of time after the issuance of the levy.[130]

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[124] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[125] Sec. 6331(a).

[126] Sec. 6331(d).

[127] Sec. 6330. The administrative hearing is referred to as the CDP hearing.

[128] Sec. 6321.

[129] Secs. 6331(d)(3) and 6861.

[130] Sec. 6330(f).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[131] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to federal contractors that are delinquent on their tax obligations. With respect to Federal payments to vendors of goods or services, the continuous levy may be up to 100 percent of each payment.[132] The term "goods or services" is not defined in the statute. The levy (either 15 percent or 100 percent) generally continues in effect until the liability is paid or the IRS releases the levy.

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and federal wage records. When the records match, the delinquent taxpayer is provided both notice of intention to levy and notice of the right to the CDP hearing 30 days before the levy is made. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy its federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or IRS releases the levy.

Description of Proposal

The proposal amends section 6331(h)(3) to add "property" to "goods or services" to allow the IRS can levy 100 percent of any payment due to a Federal vendor with unpaid Federal tax liabilities, including payments made for the sale or lease of real estate and other types of property not considered "goods or services."

Effective Date

The proposal applies to levies approved after the date of enactment.

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

[132] Sec. 6331(h)(3).

F. Application of Continuous Levy to Employment Tax Liability of Certain Federal Contractors

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property or rights to property to pay the taxpayer's tax liability.[133] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[134] and the IRS has provided both notice of intention to levy[135] and notice of the right to an administrative hearing (referred to as a collections due process notice or "CDP" notice)[136] at least thirty days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[137]

The 30-day pre-levy notice requirements, the taxpayer's rights before, during, and following the CDP hearing, and the Federal payment levy program are discussed below.

Pre-levy notice requirements

The notice of intent to levy and the CDP notice must include a brief statement describing the following: (1) the statutory provisions and procedures for levy, (2) the administrative appeals available to the taxpayer, (3) the alternatives available to avoid levy, and (4) the provisions and procedures regarding redemption of levied property.[138] In addition, the collection due process notice must include the following: (1) the amount of the unpaid tax, and (2) the right to request a hearing during the 30-day period before the IRS serves the levy.

[133] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[134] Sec. 6331(a).

[135] Sec. 6331(d).

[136] Sec. 6330. The administrative hearing is referred to as the CDP hearing.

[137] Sec. 6321.

[138] Sec. 6330(a)(3), 6331(d)(4). In practice, the notice of intent to levy and the collections due process notice is provided together in one document, Letter 1058, *Final Notice, Notice of Intent to Levy and Notice of Your Right to a Hearing*. Chief Counsel Advice Memorandum 2009-041 (November 28, 2008)

Upon receipt of this information, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office.[139] Otherwise, the IRS will levy after expiration of 30 days from the notice.

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable in permitting assessment of tax without following the normal deficiency procedures.[140]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a Federal tax liability from a state tax refund. In addition, a levy issued to collect Federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the 2-year period before the beginning of the taxable period with respect to which the employment tax levy is served. The taxpayer, however, in each of these three cases, is provided an opportunity for a hearing within a reasonable period of time after the levy.[141]

CDP hearing

At the CDP hearing, the taxpayer may present defenses to collection as well as arguments disputing the merits of the underlying tax debt if the taxpayer had no prior opportunity to present such arguments.[142] In addition, CDP includes the right to negotiate an alternative form of payment, such as an offer-in-compromise, under which the IRS would accept less than the full amount, or an installment agreement under which payments in satisfaction of the debt may be made over time rather than in one lump sum, or some combination of such measures.[143] If a taxpayer exercises any of these rights in response to the notice of intent to levy, the IRS may not proceed with its levy.

After the CDP hearing, a taxpayer also has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination.[144] During this time period, the IRS may not proceed with its levy.

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[139] Sec. 6330(b).

[140] Secs. 6331(d)(3) and 6861.

[141] Sec. 6330(f).

[142] Sec. 6330(c).

[143] Sec. 6330(c)(2).

[144] Sec. 6330(d).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[145] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to Federal contractors that are delinquent on their tax obligations. The levy generally continues in effect until the liability is paid or the IRS releases the levy.[146]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and Federal wage records. When the records match, the delinquent taxpayer is provided both notice of intention to levy and notice of the right to the CDP hearing 30 days before the levy is made. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy its federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or IRS releases the levy.

On the other hand, upon receipt of this information, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office. Also, after the CDP hearing, a taxpayer has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination. During this time period, the IRS may not proceed with its levy.

Description of Proposal

The proposal allows the IRS to issue levies prior to a CDP hearing for Federal employment tax liabilities of Federal contractors identified under the Federal Payment Levy Program. When a levy is issued prior to a CDP hearing under this proposal, the taxpayer has an opportunity for a CDP hearing within a reasonable time after the levy.

Effective Date

The proposal applies to levies issued after December 31, 2010.

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

[146] Sec. 6331(h). With respect to Federal payments to vendors of goods or services (not defined), the continuous levy may be up to 100 percent of each payment. Sec. 6331(h)(3).

G. Require Minimum Term for Grantor Retained Annuity Trusts (GRATs)

Present Law

Overview

Present law provides special rules for valuing certain transfers in trust of temporal interests in property (such as annuity interests and remainder interests).[147] Present law also provides rules for determining when a grantor of a trust will be treated as the owner of all or part of the trust for income tax purposes.[148] Grantor retained annuity trusts (GRATs) and charitable lead trusts (CLTs) are two vehicles, often structured as grantor-owned, that are used to make transfers of temporal interests in property.

Valuation of certain transfers in trust

In the event of a lifetime transfer in trust to (or for the benefit of) a member of the transferor's family where the transferor or an applicable family member retains any interest in the trust, a special rule applies for purposes of determining the value of the transferor's gift.[149] In general, the value of any retained interest that is not a "qualified interest" is treated as zero.[150] Therefore, where a transferor retains an interest that is not a qualified interest, the entire amount transferred to the trust generally is treated as a gift by the transferor to the remainder beneficiaries, which gift is subject to transfer taxation.[151] The value of a retained interest that is a qualified interest, on the other hand, is determined using rates and procedures described in the Code for valuing temporal interests in property.[152]

For these purposes, the term "qualified interest" means: (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually (i.e., a qualified annuity interest); (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually) (i.e., a qualified unitrust interest); and (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2) (i.e., a qualified remainder interest).[153]

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[147] See sec. 2702.

[148] See secs. 671-679.

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

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

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

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

[153] Sec. 2702(b).

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

"Grantor trust" rules

For income tax purposes, a trust generally is a separate taxpayer. Under certain circumstances, however, a grantor is treated as the owner of all or part of a trust for income tax purposes.[154] When a grantor is treated as owner of a trust, the grantor, when computing his or her taxable income and credits, generally must include items of income, deductions, and credits of the trust attributable to the portion of the trust deemed owned by the grantor for income tax purposes.[155]

The Code includes a number of rules regarding when a grantor or another person is treated as the owner of all or part of a trust for income tax purposes.[156] A grantor may, for example, be treated as the owner of a trust for income tax purposes where the grantor has: (1) a sufficient reversionary interest in the corpus or income of the trust;[157] (2) the power to control beneficial enjoyment of the corpus or income of the trust;[158] (3) certain administrative powers;[159] (4) the power to revoke all or part of the trust;[160] or (5) the power to distribute income to or for the benefit of the grantor.[161]

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

Grantor retained annuity trusts

A GRAT generally is an irrevocable trust in which the grantor retains an annuity interest structured as a "qualified interest" under section 2702. The annuity interest must be an irrevocable right to receive a fixed amount at least annually.[162] The trustee must be required to

[154] See secs. 671-679.

[155] See sec. 671.

[156] See secs. 673-677.

[157] Sec. 673.

[158] Sec. 674.

[159] Sec. 675.

[160] Sec. 676.

[161] Sec. 677.

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

invade the principal of the trust in the event the income is insufficient to pay the qualified annuity.

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

When the grantor's retained annuity interest expires, the trust assets are distributed to one or more remainder beneficiaries identified in the trust instrument. Because the value of the transferor's gift for gift tax purposes is determined at the time of the transfer, if trust property grows at a rate in excess of the growth rate assumed under section 7520, the excess appreciation generally will pass to the remainder beneficiaries without further gift tax consequences to the grantor. If, however, the grantor dies during the trust term, that portion of the trust necessary to generate the annuity amount will be included in the grantor's gross estate for estate tax purposes.[163] Such inclusion generally results in the loss of the transfer tax benefit of using a GRAT.

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

Description of Proposal

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

Effective Date

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

[163] Sec. 2036.

H. Increase in Information Return Penalties

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721, any person who is required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the "second-tier penalty"), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return (the "third-tier penalty"), with a maximum penalty of $250,000 per calendar year. If a failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is $100, with no calendar year limit.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

Description of Proposal

The proposal increases the first-tier penalty from $15 to $30, and increases the calendar year maximum from $75,000 to $250,000. The second-tier penalty is increased from $30 to $60, and the calendar year maximum is increased from $150,000 to $500,000. The third-tier penalty is increased from $50 to $100, and the calendar year maximum is increased from $250,000 to $1,500,000. For small business filers, the calendar year maximum is increased from $25,000 to $75,000 for the first-tier penalty, from $50,000 to $200,000 for the second-tier penalty, and from $100,000 to $500,000 for the third-tier penalty. The minimum penalty for each failure due to intentional disregard is increased from $100 to $250. The proposal also provides that every five years the penalty amounts will be adjusted to account for inflation.

Effective Date

The proposal applies with respect to information returns required to be filed on or after January 1, 2011.