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DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the tax provisions that are included in the President's fiscal year 2011 budget proposal, as submitted to the Congress on February 1, 2010.[2] The document generally follows the order in which the provisions are set forth in the table providing estimates of the revenue effects of the revenue proposals contained in the President's budget proposals.[3] For each provision, there is a description of present law and the proposal (including effective date), a reference to relevant prior budget proposals or recent legislative action, and an analysis of policy issues related to the proposal.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal* (JCS-2-10), August 16, 2010.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011*; see also Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010.

[3] See Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, (JCX-7-10R), March 15, 2010.

I. INDEX THE INDIVIDUAL ALTERNATIVE MINIMUM TAX AMOUNTS FOR INFLATION

Present Law

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

The exemption amounts are: (1) $70,950 for taxable years beginning in 2009 and $45,000 in taxable years beginning after 2009 in the case of married individuals filing a joint return and surviving spouses; (2) $46,700 for taxable years beginning in 2009 and $33,750 in taxable years beginning after 2009 in the case of other unmarried individuals; (3) $35,475 for taxable years beginning in 2009 and $22,500 in taxable years beginning after 2009 in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2010, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2009, the nonrefundable personal credits (other than the child credit, the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric drive motor vehicles, the credit for alternative motor vehicles, and credit for new qualified plug-in electric drive motor vehicles) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The remaining nonrefundable personal credits are allowed to the full extent of the individual's regular tax and alternative minimum tax.[4]

Description of Proposal

The proposal provides that the individual AMT exemption amounts, the thresholds for the phaseout of the exemption amounts, and the threshold amounts for the beginning of the 28-percent bracket are indexed for inflation from the levels in effect for 2009.

The proposal allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective date.–The proposal is effective for taxable years beginning after 2009.

Analysis

Allowing the nonrefundable personal credits to offset the regular tax and alternative minimum tax, and increasing the exemption amounts, will substantially reduce the number of taxpayers affected by the AMT. In addition to the reduction in tax liability as a result of this change, there will be significant simplification benefits. Substantially fewer taxpayers will need to complete the alternative minimum tax form (Form 6251), and the forms and worksheets relating to the various credits can be simplified.

By permanently establishing the AMT exemption levels and ability to take nonrefundable credits against the AMT, the proposal provides greater certainty for taxpayers as to their tax obligation resulting from the AMT, in comparison to the practice over the past years of annually adjusting the exemption levels to prevent their reversion to the levels in effect prior to EGTRRA. Additionally, by indexing the AMT system for inflation, as is done in the regular tax system, the proposal prevents tax increases in real terms for the portion of one's income growth that merely accounts for inflationary growth. By doing so, the proposal substantially slows the rate of growth in the number of taxpayers subject to the AMT over time.

A number of analysts argue that the proposal does not go far enough, advocating instead the abolition of the AMT. Their argument rests on the observation that the AMT system has outlived its original purpose of requiring taxpayers engaged in substantial sheltering of income to pay at least some minimum tax. Instead, taxpayers today are mainly ensnared by the AMT as a result of their income level, payment of state and local taxes, and presence of dependents. Such analysts argue that requiring such taxpayers to calculate their liability two ways is needlessly complex and serves no discernible policy objective that the regular tax alone couldn't provide.

[4] The rule applicable to the child credit after 2010 is subject to the EGTRRA sunset. The adoption credit is refundable in 2010 and 2011 and beginning in 2012 is nonrefundable and treated in the same manner as the child credit.

II. MAKE PERMANENT AND MODIFY CERTAIN TAX CUTS ENACTED IN 2001 AND 2003

A. Dividends and Capital Gains Tax Rate Structure

Present Law

Dividends

In general

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Tax rates before 2011

An individual's qualified dividend income is taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2011, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Qualified dividend income generally includes dividends received from domestic corporations and qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (1) the qualified dividend income of the RIC for the taxable year and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust ("REIT") for any taxable year may not exceed the sum of (1) the qualified dividend income of the REIT for the taxable year, (2) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.[5]

Tax rates after 2010

For taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income tax rates.

Capital gains

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income. Net capital gain is the excess of the net

[5] In addition, for taxable years beginning before 2011, amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent; and the collapsible corporation rules (sec. 341) are repealed.

long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Tax rates before 2011

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. These rates apply for purposes of both the regular tax and the AMT.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

An individual's unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

Tax rates after 2010

For taxable years beginning after December 31, 2010, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent capital gain rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2011.

Description of Proposal

Under the proposal, the tax rates in effect before 2011 are made permanent. In addition, a 20-percent tax rate will apply to adjusted net capital gain and qualified dividend income for married individuals filing a joint return with adjusted gross income over $250,000 and unmarried taxpayers with adjusted gross income over $200,000. These dollar amounts are indexed for inflation.

Effective date.−The proposal applies to taxable years beginning after December 31, 2010.

Analysis

Dividends

Under present law, the United States has a "classical" system of taxing corporate income. Under this system, corporations and their shareholders are treated as separate persons. A tax is imposed on the corporation on its taxable income, and after-tax earnings distributed to individual shareholders as dividends are included in the individual's income and taxed at the individual's tax rate. This system creates the so-called "double taxation of dividends." Prior to 2003, corporate dividends received by an individual taxpayer were taxed at the same rate as ordinary income. By reducing the tax rate applicable to dividends in 2003, the Congress hoped to mitigate the double taxation of dividends and the implicit bias in favor of returns received from ownership of corporate equity in the form of capital gains. This was intended to reduce economic distortions.

The classical system, it is argued, results in economic distortions. Economically, the issue is not that dividends are taxed twice, but rather the total tax burden on income from different investments. Business investments in entities not subject to corporate tax, such as partnerships, limited liability companies, and S corporations generally are taxed more favorably. An investment in a C corporation that returned $100 would pay a $35 corporate income tax and then, if the remaining $65 were paid out as a dividend to a shareholder in the highest individual income tax bracket (presently 35 percent), the shareholder would net $42.25. Had the investment been made through a partnership, the taxpayer would have received $65 ($100 - ($100 multiplied by 35 percent)) after tax. Thus, analysts observe that because a classical system creates different after-tax returns to investments undertaken in different legal forms the choice of legal entity is distorted and economic efficiency is reduced.

Critics of a classical system argue that a classical system distorts corporate financial decisions. They argue that because interest payments on the debt are deductible, while dividends are taxable, a classical system encourages corporations to finance using debt rather than equity. They observe that the increase in corporate leverage, while beneficial to each corporation, may place the economy at risk to more bankruptcies during an economic downturn.

Similarly, a classical system encourages corporations to retain earnings rather than to distribute them as taxable dividends. Drawing on the example above, if the corporation had retained the $65 of income net of the corporate income tax, the value of the corporation should increase by $65. If shareholders sold their shares, under present law they would recognize the $65 as a capital gain and generally incur a $9.75 income tax liability. Thus, a retention policy could result in net income to the shareholder of $55.25 as opposed to $42.25 if income were paid out as a dividend.[6] This difference in effective tax burden may mean that shareholders prefer that corporate management retain and reinvest earnings rather than pay out dividends, even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings. This is another source of inefficiency as the opportunity to earn higher pre-tax returns is passed up in favor of lower pre-tax returns. The present-law reduced rate of tax on qualified corporate dividends narrows the difference in effective tax burden between a policy of dividends and a policy of retaining earnings.

Proponents of the reduced rates of tax on dividend income under present law observe that by reducing the aggregate tax burden on investments made by corporations, the proposal would lower the cost of capital needed to finance new investments and may increase investment in the aggregate as well as investment by C corporations. Increased investment ultimately should lead to increased labor productivity, higher real wages, and increased long-term economic growth. However, there is no consensus about the magnitude of the long-run responsiveness of investment to changes in the cost of capital.

The simple examples used above to illustrate potential sources of economic inefficiency in a classical system may overstate the aggregate tax burden on investments made by C

[6] In practice the effective tax rate difference between the dividend policy and retention policy would be greater. This simple example assumes the capital gain is recognized immediately. Taxpayers can choose to defer recognition of gain. By deferring gain, the effective tax burden on the gain declines.

corporations. Critics of present law have questioned whether there is a substantial effect on corporate investment because persons not subject to the individual income tax (e.g., foreign persons and tax-exempt institutions such as pension funds) hold substantial amounts of corporate equity. If these shareholders are the providers of incremental investment funds, present law generally does not change the aggregate tax burden on an investment made by a C corporation. Critics of present law also observe that, in the early years, much of the tax reduction from reduced taxes on dividend income accrues to returns to investments made by C corporations in the past and not new investment. Moreover, critics observe that, as corporate stock when held by individuals outside of tax-favored retirement accounts is generally held more extensively by taxpayers above the median income, the benefit of the present-law reduced rates of tax most directly benefits higher-income taxpayers.

Capital gains

Both present law and the Administration's proposal would provide for a maximum tax rate on income from realized capital gains that is less than the tax rate applicable to a taxpayer's income from labor income (wages and salary) and from other types of capital income (for example, interest, dividends, and rental income). The differential in tax rates between income from realized capital gains and other sources of income raises several policy issues.

- Does a differential rate promote improved efficiency of the capital markets?
- Does a differential rate promote the socially optimal level of risk taking?
- Does a differential rate promote long-run economic growth?
- Is income from capital gains properly measured?
- Is a differential in rates consistent with policy maker's equity goals?

Does a differential rate promote improved efficiency of the capital markets?

Many argue that higher tax rates discourage sales of assets. For individual taxpayers, this "lock-in effect" is exacerbated by the rules that allow a step-up in basis at death and defer or exempt certain gains on sales of homes. As an example of what is meant by the lock-in effect, suppose a taxpayer paid $500 for a stock that now is worth $1,000, and that the stock's value will grow by an additional 10 percent over the next year with no prospect of further gain thereafter. Assuming a 20-percent tax rate, if the taxpayer sells the stock one year or more from now (when it is worth $1,100), he or she will net $980 after payment of $120 tax on the gain of $600. With a tax rate on gain of 20 percent, if the taxpayer sold this stock today, he or she would have, after tax of $100 on the gain of $500, $900 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.1 percent. With a tax rate on gain of 28 percent, the alternative investment would need to earn a total pre-tax return in excess of 11.6 percent to justify a switch, while the required rate of return with a 15-percent tax rate is only 10.8 percent. Preferential tax rates on capital gains impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. When the tax imposed on removing monies from old investments is reduced, taxpayers would not necessarily redirect their funds to new investments when their monies in older investments are unlocked. Taxpayers might instead choose to consume the proceeds. Some have suggested that the lock-in effect could be reduced without lowering taxes on old investments. For example, eliminating the step-up in basis upon death would reduce lock-in.

To the extent that preferential rates may encourage investments in stock, and more specifically stock that offers its return in the form of capital gain rather than dividends, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Non-neutral treatment generally is not consistent with capital market efficiency. On the other hand, it is argued that asset neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Does a differential rate promote the socially optimal level of risk taking?

Some maintain that a preferential capital gains tax rate encourages investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. In theory, when a tax system accords full offset for capital losses, a reduction in tax rates applicable to capital gains would reduce risk taking. This is because with full loss offset the government acts like a partner in the investment, bearing an equal share of the risk, both good and bad. The reduction in tax rates reduces the government's share in gains and losses such that less risk is necessary to generate the same amount of after-tax income and the investor bears more of any loss.[7] However, the present-law limitation on taxpayers' ability to offset capital losses against other income creates a bias against risk taking by implicitly reducing the value of any loss by deferring its inclusion in income. A reduction in the tax rate on realized gain, proponents argue, therefore should increase risk taking. Proponents argue that the preference provides an incentive for investment and capital formation, with particular importance for venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate, broadly applied, is not targeted toward any particular type of equity investment. They note that a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments. They observe that present-law section 1202 (that provides individual holders of certain small businesses with a reduced tax on realized capital gains) and present-law section 1244 (that provides expanded loss offset for investments in certain small business stock) more specifically target risk-taking activities.

[7] Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking," *Quarterly Journal of Economics*, 58, May 1944.

The President's budget proposal also would expand the tax benefit under section 1202 by creating a tax rate of zero for qualified investments.[8] Proponents aver that it is important to provide a preference to equity investments in small businesses as they create the industries of the future. Opponents of such a capital gains preference point out that a tax preference could have only a small incentive effect on investment because a large source of venture capital and other equity investment is tax-exempt or partially tax-exempt entities (for example, pension funds and certain insurance companies and foreign investors). For example, in 2008, tax-exempt entities (including public pension funds, endowments, foundations, sovereign wealth funds, and union pension funds) contributed nearly 44 percent of new venture capital funds.[9] On the other hand, proponents argue that preferential capital gains treatment for venture capitalists who are taxable is important. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital. They further observe that initial investors in new ventures are frequently friends and family of the entrepreneur, all of whom are taxable. The organized venture capitalists are more prevalent at later stages of financing. They observe that small businesses face a higher cost of capital than do larger, established businesses. However, a higher cost of capital does not necessarily indicate a market failure for which a tax subsidy might be justified. Small businesses are inherently risky. The majority of small businesses do not survive their first year. A higher cost of capital may only reflect market realities in assuming risk by investors and not a flaw in the capital markets. Others note that the Federal government has developed loan programs administered through the Small Business Administration to address the higher cost of capital faced by many small businesses. Proponents of a reduced capital gains tax rate on equity investments in small businesses argue that unlike the programs of the Small Business Administration, the proposed tax benefit is not limited by the appropriations process and is open to all businesses that meet the qualifying standards. They note that the market would still remain the judge of where to allocate investments among qualifying small businesses.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program. On the other hand, the capital gains preference may make equity more attractive than debt, the returns on which are taxed at ordinary income tax rates.

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[8] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010, Analytical Perspectives* (H. Doc. 111-3, Vol. III), at 267.

[9] Dow Jones Private Equity Analyst, Sources of Capital, 2009, at 4, available at http://www.fis.dowjones.com/products/privateequityanalyst.html

Does a differential rate promote long-run economic growth?

The United States has a low rate of household saving, averaging less than five percent of disposable income for more than the past decade.[10] This rate is low both in comparison to other industrialized countries and in comparison to prior United States experience. At the aggregate level, a low saving rate is a concern because saving provides the wherewithal for investment in productivity-enhancing equipment and technology. At the household level, a low saving rate may imply households are accumulating insufficient assets for retirement, emergencies, or other uses. By reducing the tax on realized capital gains, the after-tax return to household saving is increased.

Theoretically, the effect on saving of a reduction of taxes on capital income is ambiguous. There are two effects. First, the increased return to saving should encourage people to save more. Second, the increased return people receive on assets they have already accumulated and on saving they had already planned increases their income. This increased income may encourage them to increase their consumption and may reduce their saving. Empirical economic evidence also is ambiguous on whether, or if at all, household saving responds to changes in the after-tax rate of return.

In addition, reduction in only the tax applicable to capital gains may prove to be an inefficient saving incentive. By favoring certain types of assets (those that generate returns in the form of accrued gains) over other types of assets (those that generate returns in the form of interest, dividends, or royalties), taxpayers may reallocate their holdings of assets to obtain higher after-tax returns without saving new funds. Such portfolio reallocations also represent reduced efficiency of capital markets as choices have been distorted. As noted above, the application of a reduced tax on capital gains to those who currently hold assets with accrued gains could lead to reduced saving as households sell those assets and increase consumption from the proceeds.

Is income from capital gains properly measured?

Some proponents of lower tax rates on income from capital gain observe that the preference may provide taxpayers some rough compensation for inflation. Part of the gain represents the effects of inflation and does not constitute real income.

Others note that a preferential tax rate is a very crude adjustment for inflation. In addition, as income taxed upon realization, generally at the taxpayer’s discretion, a taxpayer realizing income from a capital gain enjoys a tax benefit from the deferral of tax on accrued appreciation until the asset is sold. The following example illustrates the benefit of deferral. Assume a taxpayer in the 15-percent tax bracket has $1,000 to invest and may choose between two investment alternatives, each of which generates a return of 10 percent annually. Assume the one investment is a certificate of deposit that pays the 10-percent return out annually as interest on which the taxpayer must pay tax. After paying tax, the taxpayer reinvests the

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[10] Council of Economic Advisers, *Economic Report of the President*, (Washington, D.C.: U.S. Government Printing Office), January 2009, at 320.

principal and net proceeds in a new certificate of deposit. The other investment, stock in a company that pays no dividends, accrues the 10-percent return untaxed until a capital gain is realized. After eight years the after-tax value of the taxpayer's certificate of deposit would be \$1,920.[11] After selling the stock and paying tax on the realized gain, the taxpayer would have \$1,972.[12] Another way to characterize the benefit of deferral is that the effective rate of taxation on realized capital gains is less than the rate of taxation applicable to assets that pay current income. In this particular example, the effective rate of taxation on the realized capital gain is 11.4 percent, rather than the statutory tax rate of 15 percent.[13] On the other hand, proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation.

<u>Is a differential in rates consistent with policy maker's equity goals?</u>

A lower rate of tax for income from capital gains compared to the tax rate applicable to other income will benefit directly those taxpayers who hold assets with accrued capital gains. Information is somewhat scant regarding the distribution of assets with accrued capital gains among different taxpayers. Tax return data contain information on which taxpayers have realized capital gains in the past. These data reveal that many taxpayers realize a capital gain from time to time, but the majority of the dollar value of gains realized is by taxpayers who frequently realize capital gains. Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, the bulk of the dollar value of any tax reduction will go to those taxpayers who realize the bulk of the dollar value of gains.

The data also suggest that taxpayers who infrequently realized capital gains generally have lower incomes than those taxpayers who frequently realized capital gains. These findings have been criticized because income is sometimes measured including the realized gain. However, attempts to account for this problem by measuring income less realized gains or by using a measure of income averaged over a period of years generally reveal that a large portion of the dollar value of gains are realized by higher-income taxpayers while a large portion of the transactions in which gains are realized are undertaken by the remaining taxpayers. Such findings are consistent with information on the ownership of assets in the United States. Higher-income taxpayers generally hold a larger proportion of corporate stock and other capital assets than do other taxpayers. Thus, while many taxpayers may benefit from a lower rate of tax on income from capital gains, a larger proportion of the dollar value of a lower tax rate on capital gain income will go to those higher-income taxpayers who realize the bulk of the dollar value of gains.

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[11] This is calculated as $1{,}000(1 + r(1 - t))^n$, where r is the interest rate (10 percent in this example), t is the marginal tax rate (15 percent in this example), and n is the number of years the asset is held (eight in this example).

[12] This is calculated as the \$1,000 principal plus the net, after-tax gain of $(1{,}000(1 + r)^n - 1{,}000)(1 - t)$, where r is the interest rate (10 percent), t is the marginal tax rate (15 percent), and n is the number of years the asset is held (eight).

[13] The effective rate of taxation on a realized gain is calculated by asking what rate of tax on an asset that paid current income would yield an equivalent amount of net proceeds to the taxpayer if that asset were held until the taxpayer realized the capital gain.

Complexity and tax rate differentials for income from dividends and capital gains

The combination of present law and the proposed changes of the President's Fiscal Year 2010 budget proposal creates a complex structure of tax rates for different types of investments.

Tables 1 through 3, below, detail the tax rates applicable to income from different investments yielding income from dividends and capital gains.

Table 1.–Individual Tax Rates Applicable Under Present Law to Certain Categories of Income, 2010

	Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**33%**	**35%**	**26%**	**28%**
Dividend income	0	0	15	15	15	15	same as regular tax	
Short-term capital gain[1]	10	15	25	28	33	35	26	28
Long-term capital gain[2]	0	0	15	15	15	15	same as regular tax	
Section 1250 gain[3]	10	15	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	26	28
Small business stock[4]	0	0	12.5	14	14	14	13.91	14.98
Empowerment zone small business stock[5]	0	0	10	11.2	11.2	11.2	11.592	12.376
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0	0

Table 2.–Individual Tax Rates Applicable Under Present Law to Certain Categories of Income, 2011 and Thereafter

	Regular Tax Rate Bracket					Minimum Tax Rate Bracket	
Category of income	**15%**	**28%**	**31%**	**35%**	**39.6%**	**26%**	**28%**
Dividend income	15	28	31	35	39.6	26	28
Short-term capital gain[1]	15	25	31	35	39.6	26	28
Long-term capital gain[2]	10	20	20	20	20	same as regular tax	
Section 1250 gain[3]	15	25	25	25	25	25	25
Collectible gain	15	28	28	28	28	26	28
Small business stock issued before February 18, 2009, or after December 31, 2010.[4]	7.5	14	14	14	14	18.46[7]	19.88[7]
Empowerment zone small business stock issued before February 18, 2009, or after December 31, 2010	6	11.2	11.2	11.2	11.2	14.768	15.904
Small business stock issued after February 17, 2009, and before January 1, 2011	3.75	7	7	7	7	11.76	12.88
Five-year gain acquired before 2001	8	20	20	20	20	same as regular tax	
Five-year gain acquired after 2000	8	18	18	18	18	same as regular tax	
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0

Table 3.–Individual Tax Rates Applicable Under Administration Proposal to Certain Categories of Income, 2011 and Thereafter

	Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**36%**	**39.6%**	**26%**	**28%**
Dividend income	0	0	15	15	20	20	same as regular tax	
Short-term capital gain[1]	10	15	25	28	36	39.6	26	28
Long-term capital gain[2]	0	0	15	15	20	20	same as regular tax	
Section 1250 gain[3]	10	15	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	26	28
Small business stock issued before February 18, 2009[4]	0	0	12.5	14	14	14	13.91	14.98
Empowerment zone small business stock issued before February 18, 2009	0	0	10	11.2	11.2	11.2	11.592	12.376
Small business stock issued after February 17, 2009	0	0	0	0	0	0	0	0
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0	0

Notes:
[1] Gain from assets held not more than one year.
[2] Gain from assets held more than one year not included in another category.
[3] Capital gain attributable to depreciation on section 1250 property (i.e., depreciable real estate).
[4] Effective rates after application of 50-percent exclusion for small business stock held more than five years.
[5] Effective rates after application of 60-percent exclusion for small business empowerment zone stock held more than five years.
[6] D.C. Enterprise Zone stock issued after December 31, 1997, and before January 1, 2010, and Renewal Community stock issued after December 31, 2001, and before January 1, 2010. The stock must be held for more than five years.
[7] If the holding period for the stock begins after 2000, the rates are 16.64% and 17.92%, respectively.

Beyond any difficulties the various rates may create for a taxpayer's calculation of his or her tax liability, opponents of a preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange treatment, asset allocation, and many other issues has been extensive in the past. A significant body of law, based both in the tax code and in judicial rules, has developed in response to conflicting taxpayer and IRS positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for taxpayers to take aggressive tax return positions. It has been argued that the results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service.

Furthermore, it is argued that so long as a limitation on deductions of capital loss is retained, some areas of uncertainty and dispute will continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business). Because limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the potential for simplification and consistency may be limited.

Prior Action

The American Recovery and Reinvestment Tax Act of 2009 changed the applicable tax rates for qualified small business stock issued after February 17, 2009, and before January 1, 2011.

B. Extend Temporary Increase in Expensing for Small Business

Present Law

Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[14] For taxable years beginning after 2007 and before 2011, the maximum amount that a taxpayer may expense is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000.[15] Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[16]

For taxable years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software).

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[14] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

[15] The temporary $250,000 and $800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, and extended for taxable years beginning in 2010 by the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147 (the "HIRE Act of 2010").

[16] Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

Description of Proposal[17]

The proposal increases permanently the amount a taxpayer may deduct under section 179.[18] The proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2010, is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation.

In addition, off-the-shelf computer software is treated as qualifying property. Further, a taxpayer is permitted to make or revoke an election for a taxable year under section 179 on an amended Federal tax return for that taxable year without the consent of the Commissioner.

Effective date.–The proposal is effective for taxable years beginning after 2010.

Analysis

The proposal lowers the after-tax cost of capital expenditures made by businesses within a certain size range by permitting the immediate depreciation of the full amount of the capital expenditure (i.e., expensing), rather than depreciation of the expenditure over the recovery period. With a lower cost of capital, it is argued that eligible businesses will invest in more equipment and employ more workers, thus serving to stimulate economic growth among eligible businesses taxable in the United States.

Expensing of capital investments is the appropriate treatment if the policy objective is to tax consumption, because expensing effectively eliminates tax on the returns to investment, subject to certain assumptions.[19] If the objective is to tax income, then depreciation deductions should coincide with the economic depreciation of the asset to measure economic income accurately. A depreciation system more generous than economic depreciation, but less generous

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17 The proposal includes a provision to extend the rules under section 179 in place for taxable years beginning in 2008 and 2009 to taxable years beginning in 2010. This extension was enacted as part of the HIRE Act of 2010, as noted above.

18 This permanent increase is with reference to the rules that would, absent the proposal, apply to taxable years beginning after 2010.

19 For example, consider an investment of $100 that yields a $10 return in the following year, i.e., a 10-percent pre-tax return. If the tax rate is 50 percent, expensing of the $100 investment yields a $50 reduction in tax liability, meaning the after-tax cost to the taxpayer for the $100 investment is $50. The $10 return in the following year results in a $5 tax, and thus a $5 after-tax return. Thus, the after-tax return on the investment is 10 percent (5 divided by 50), the same as the pre-tax return. To fully effect consumption tax treatment, other modifications would need to be made, such as not imposing capital gains taxes with respect to sales of business equity interests and fully integrating the corporate and individual tax systems. Additionally, no business interest expense deductions could be permitted or negative effective tax rates would result. Finally, even with the changes above, any property taxes imposed at the State or local level would cause there to remain a positive effective tax rate on the return to investment.

than full expensing, results in an effective tax rate on the income from capital that is less than the statutory tax rate.

In addition to promoting investment, advocates of expensing assert that increased expensing eliminates depreciation recordkeeping requirements with respect to expensed property. Under the proposal, Federal income tax accounting could be simplified by increasing the portion of capital costs that are expensed in one taxable year and concomitantly reducing those that are recovered through depreciation over the recovery period. It could be argued that the simplification benefit of expensing is not fully realized, however, so long as property is partially depreciated, or so long as some but not all of the taxpayer's property that is eligible for cost recovery is expensed; the taxpayer must still keep records for that property that is subject to depreciation over a period of years.

The proposal increases the $200,000 phaseout threshold amount that would apply for taxable years beginning after 2010 to $500,000, which has the effect of generally permitting larger businesses to obtain the tax benefit of expensing. Some may argue that this result is inconsistent with the idea of limiting expensing to small businesses, as under the present-law provision. They might alternatively argue that in an income tax system, expanding the availability of expensing is not appropriate because it results in a less accurate measurement of economic income. On the other hand, it could be argued that there is no rationale for limiting expensing to businesses below a particular size or with capital expenditures below a certain level.

An advantage of making the increase in the expensing amounts permanent is that it reduces uncertainty with respect to the tax treatment of future investment, thus permitting taxpayers to plan capital expenditures with greater focus on the underlying economics of the investments, and less focus on the tax-motivated timing of investment. Removing tax-motivated distortions in the timing of investment may promote more efficient allocation of economic resources. On the other hand, legislative changes to the expensing rules (principally temporary increases in the amount that can be expensed) have been frequent in the past decade, and there is nothing to prevent additional legislative changes to the expensing rules, regardless of whether the current expensing rules are permanent or temporary. Additionally, to the extent that the rationale for the original increase in the amounts that may be expensed was to provide a counter-cyclical short-term economic stimulus, it can be argued that it is important that such provisions in fact be temporary. If there is uncertainty that a provision providing temporary tax relief may not ultimately be temporary, it can be argued that the stimulative effect of the provision is compromised because the taxpayer need not act within the originally specified time frame of the provision to benefit from it.

Prior Action

A similar proposal was included in the President's budget proposals for fiscal years 2007, 2008, 2009, and 2010.

C. Marginal Individual Income Tax Rate Reductions

Present Law

In general

The Economic Growth and Tax Relief Reconciliation Act of 2001[20] created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The otherwise applicable regular income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. These provisions of EGTRRA shall cease to apply for taxable years beginning after December 31, 2010.

Tax rate schedules

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2010, the regular individual income tax rate schedules are as follows:

[20] Pub. L. No. 107-16.

Table 4.–Federal Individual Income Tax Rates for 2010

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,375	10% of the taxable income
Over $8,375 but not over $34,000	$837.50 plus 15% of the excess over $8,375
Over $34,000 but not over $82,400	$4,681.25 plus 25% of the excess over $34,000
Over $82,400 but not over $171,850	$16,781.25 plus 28% of the excess over $82,400
Over $171,850 but not over $373,650	$41,827.25 plus 33% of the excess over $171,850
Over $373,650	$108,421.25 plus 35% of the excess over $373,650
Heads of Households	
Not over $11,950	10% of the taxable income
Over $11,950 but not over $45,550	$1,195 plus 15% of the excess over $11,950
Over $45,550 but not over $117,650	$6,235 plus 25% of the excess over $45,550
Over $117,650 but not over $190,550	$24,260 plus 28% of the excess over $117,650
Over $190,550 but not over $373,650	$44,672 plus 33% of the excess over $190,550
Over $373,650	$105,095 plus 35% of the excess over $373,650
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $16,750	10% of the taxable income
Over $16,750 but not over $68,000	$1,675 plus 15% of the excess over $16,750
Over $68,000 but not over $137,300	$9,362.50 plus 25% of the excess over $68,000
Over $137,300 but not over $209,250	$26,687.50 plus 28% of the excess over $137,300
Over $209,250 but not over $373,650	$46,833.50 plus 33% of the excess over $209,250
Over $373,650	$101,085.50 plus 35% of the excess over $373,650
Married Individuals Filing Separate Returns	
Not over $8,375	10% of the taxable income
Over $8,375 but not over $34,000	$837.50 plus 15% of the excess over $8,375
Over $34,000 but not over $68,650	$4,681.25 plus 25% of the excess over $34,000
Over $68,650 but not over $104,625	$13,343.75 plus 28% of the excess over $68,650
Over $104,625 but not over $186,825	$23,416.75 plus 33% of the excess over $104,625
Over $186,825	$50,542.75 plus 35% of the excess over $186,825

Description of Proposal

The proposal permanently extends the 10-percent, 15-percent, 25-percent and 28-percent individual income tax rates. For taxable years beginning after December 31, 2010, the 33-percent rate and the 35-percent rate brackets become 36-percent and 39.6 percent, respectively.

The proposal widens the tax rate bracket for the 28-percent rate so that individuals with less than $195,550 of taxable income in 2011 ($200,000 of adjusted gross income ("AGI"), assuming one personal exemption and the basic standard deduction, indexed from 2009) will not be subject to the new 36-percent rate.

For married individuals filing joint returns and surviving spouses, the dollar threshold for the new 36-percent bracket is set so that married couples and surviving spouses with taxable income below $237,300 in 2011 ($250,000 of AGI, assuming two personal exemptions and the basic standard deduction, indexed from 2009), currently subject to the 33-percent rate, will not become subject to the new 36-percent rate.

For head of household filers, the starting point of the 36-percent bracket is set at the midpoint of the starting points for single filers and married joint filers, rounded down to the nearest $50, or $216,400.

A comparison of Table 5, below, with Table 4, above, illustrates proposed tax rate changes. Note that Table 5 also incorporates the President's proposal to retain the marriage penalty relief with respect to the size of the 15 percent rate bracket, as discussed in section II.F.

Table 5.–Federal Individual Income Tax Rates for 2011
Under the President's Proposal

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,575	10% of the taxable income
Over $8,575 but not over $34,850	$858 plus 15% of the excess over $8,575
Over $34,850 but not over $84,350	$4,799 plus 25% of the excess over $34,850
Over $84,350 but not over $195,550	$17,174 plus 28% of the excess over $84,350
Over $195,550 but not over $382,650	$48,310 plus 36% of the excess over $195,550
Over $382,650	$115,666 plus 39.6% of the excess over $382,650
Heads of Households	
Not over $12,250	10% of the taxable income
Over $12,250 but not over $46,650	$1,225 plus 15% of the excess over $12,250
Over $46,650 but not over $120,500	$6,385 plus 25% of the excess over $46,650
Over $120,500 but not over $216,400	$24,848 plus 28% of the excess over $120,500
Over $216,400 but not over $382,650	$51,700 plus 36% of the excess over $216,400
Over $382,650	$111,550 plus 39.6% of the excess over $382,650
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,150	10% of the taxable income
Over $17,150 but not over $69,700	$1,715 plus 15% of the excess over $17,150
Over $69,700 but not over $140,600	$9,598 plus 25% of the excess over $69,700
Over $140,600 but not over $237,300	$27,323 plus 28% of the excess over $140,600
Over $237,300 but not over $382,650	$54,399 plus 36% of the excess over $237,300
Over $382,650	$106,725 plus 39.6% of the excess over $382,650
Married Individuals Filing Separate Returns	
Not over $8,575	10% of the taxable income
Over $8,575 but not over $34,850	$857.50 plus 15% of the excess over $8,575
Over $34,850 but not over $70,300	$4,799 plus 25% of the excess over $34,850
Over $70,300 but not over $118,650	$13,661.50 plus 28% of the excess over $70,300
Over $118,650 but not over $191,325	$27,199.50 plus 36% of the excess over $118,650
Over $191,325	$53,362.50 plus 39.6% of the excess over $191,325

Effective date.−The proposal applies to taxable years beginning after December 31, 2010.

Analysis

The proposal provides tax relief to a large percentage of taxpayers, which will provide incentives for these taxpayers to work, to save, and to invest and, thereby, will have a positive effect on the long-term health of the economy. The proposal also results in increased marginal tax rates on upper income taxpayers (as is provided for by the present-law sunset of EGTRRA), which will correspondingly reduce incentives for these taxpayers to work, to save, and to invest. Opponents of this latter aspect of the proposal often note that many small businesses, and a large fraction of small business income, will be adversely impacted by an increase in the top two tax rates. The staff of the Joint Committee on Taxation estimates that in 2011 just under 750,000 taxpayers with net positive business income (3 percent of all taxpayers with net positive business income) will have marginal rates of 36 or 39.6 percent under the President's proposal, and that 50 percent of the approximately $1 trillion of aggregate net positive business income will be reported on returns that have a marginal rate of 36 or 39.6 percent.[21]

Some argue that an increase in the top two tax rates may lead to a greater disincentive to take entrepreneurial risks as the government will take a larger share of any marginal gains from successful ventures. On the other hand, proponents of the proposal observe that, despite these negative consequences, it is appropriate to allow the rates to rise for relatively few upper income taxpayers on account of pressing needs for Federal revenues, deficit reduction and distributional concerns.

Some opponents of any extension of the EGTRRA rates argue that the projections for prolonged Federal deficits should be dealt with more aggressively even if it requires allowing more of the EGTRRA tax relief to expire. They argue that the long-term economic effects of the increased Federal debt needed to support projected spending and tax relief will adversely affect the United States' long-term economic prospects. Further, they argue that the tax cuts will reduce the ability of the Federal government to pay down the public debt, fund priorities such as education and defense, and secure the future obligations of Social Security and Medicare.

Prior Action

Proposals to extend permanently the 10-percent, 15-percent, 25-percent, and 28-percent individual income tax rates were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009 and 2010 budget proposals.

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[21] This analysis excludes taxpayers subject to the AMT. Business income consists of income from sole proprietorships (Schedule C); income from rental real estate, royalties, partnerships, subchapter S corporations, estates and trusts, and real estate mortgage investment conduits (Schedule E); and farm income (Schedule F), as would be reported on lines 12, 17, and 18 of the 2010 Form 1040. Not counted as "business income" is income from interest, dividends, or capital gains that may flow through certain pass-through entities but which is reported elsewhere on an individual's return.

D. Child Tax Credit

Present Law

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

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

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2011, is allowed against the alternative minimum tax ("AMT"). To the extent the child tax credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). EGTRRA provided, in general, that this threshold dollar amount is $10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 set the threshold at $3,000 for both 2009 and 2010. After 2010, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the "alternative formula" if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit ("EITC"). After 2010, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

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

Description of Proposal

The proposal permanently extends the $1,000 child tax credit and allows the child tax credit against the individual's regular income tax and AMT.[22] The provision also extends the EGTRRA repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT. The proposal permanently extends the earned income formula for determining the refundable child credit, with the earned income threshold of $10,000 (indexed for inflation from 2001). Finally, the proposal permanently extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

Effective date.−The proposal applies to taxable years beginning after December 31, 2010.

Analysis

This provision doubles the child tax credit (from $500 to $1,000) to provide additional tax relief to families to help offset the costs of raising a child. Proponents embrace the original arguments made for the EGTRRA provisions as support for permanently extending the provisions. Their principal argument is that a tax credit for families with children recognizes the expense of raising children and the importance of helping families raise children. Further, they argue that the refundable child credit should remain widely available to families regardless of the number of children (rather than only families with three or more children), and thus it is important to extend the earned income formula for determining the refundable credit. Additionally, they believe that the child credit should be allowed to offset the AMT.

Most observers recognize that dependent children affect a taxpayer's ability to pay tax, and believe that fact should be reflected in a taxpayer's tax liability. However, some opponents raise concerns over the cost of the extension. They also note that the dependent exemption, which provides tax relief to many of the same families with dependents as receive the child tax credit, is already part of the Code. In general, opponents argue that the EGTRRA sunset provisions, including the child credit provisions, should be addressed in the context of an overall reform of the tax Code that simultaneously addresses long-term revenue requirements.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009 and 2010 budget proposals.

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[22] See Part II.E "Increase of Refundable Portion of the Child Credit" for a related budget proposal. That proposal permanently extends a refundable child tax credit to the extent of 15 percent of the taxpayer's earned income in excess of $3,000.

E. Increase of Refundable Portion of the Child Credit

Present Law

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

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

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). Prior to the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the threshold dollar amount was $12,550 (for 2009), and is indexed for inflation. Under the ARRA, the threshold amount (beginning in 2009 and 2010) is $3,000. After 2010 the pre-ARRA rules shall apply.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit ("EITC").

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

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Description of Proposal

The proposal permanently extends the lower threshold dollar amount ($3,000) for calculation of the refundable child tax credit. Also, the proposal stops indexation for inflation of the $3,000 earnings threshold.[23]

Effective date.−The proposal applies to taxable years beginning after December 31, 2010.

Analysis

Proponents argue that the ARRA expansion of the refundable child tax credit helps offset other Federal tax liabilities to reduce the overall tax burden on working families. Opponents question whether the proliferation of refundable credits unnecessarily contributes to the complexity of the tax system. Others have also expressed concern about compliance issues with respect to refundable credits. The EITC has special rules related to taxpayers who have improperly claimed the credit in prior years, and consideration could be given to similar rules for the refundable child credit.

Prior Action

A similar provision was included in the President's fiscal year 2010 budget proposal.

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[23] Under a separate budget proposal, part II.D. for taxable years beginning after December 31, 2010, the $1,000 child tax credit and other changes are permanently extended.

F. Marriage Penalty Relief and Earned Income Tax Credit Simplification

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately continued to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately are the same.

Fifteen percent rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return.

Earned income tax credit

The earned income tax credit ("EITC") is a refundable tax credit available to certain lower-income individuals. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income, and the number of qualifying children.

Description of Proposal

Basic standard deduction

The proposal permanently increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.

15 percent rate bracket

The proposal permanently increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the 15-percent regular income tax rate bracket for an unmarried individual filing a single return. Finally, for married couples who file a joint return, the proposal permanently increases the beginning and ending points of the EITC phase-out by $5,000.[24]

Earned income tax credit

The proposal permanently extends certain EITC provisions adopted by EGTRRA. These include: (1) a simplified definition of earned income; (2) a simplified relationship test; (3) a simplified tie-breaking rule; (4) additional math error authority for the Internal Revenue Service; (5) a repeal of the prior-law provision that reduced an individual's EITC by the amount of his alternative minimum tax liability; and (6) increases in the beginning and ending points of the credit phase-out for married taxpayers.

Effective date.−The proposal applies to taxable years beginning after December 31, 2010.

Analysis

Basic standard deduction and 15-percent rate bracket

Proponents of the extension of these provisions are concerned about the inequity that arises when two working single individuals marry and experience a tax increase solely by reason of their marriage (a "marriage penalty"). Proponents argue that the expansion of the standard deduction and the 15-percent rate bracket for married couples filing joint returns would eliminate the effects of the marriage tax penalty for most taxpayers, and alleviate the effects for others.

Some analysts have suggested that the marriage penalty may alter taxpayers' decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before marriage, but it also generally may result in one or both of the formerly single taxpayers being in

[24] The amount is indexed for inflation annually.

a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 28-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first $9,350 of his earnings would be tax-free.[25] However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor.[26] Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. The preponderance of economic evidence shows that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.[27] In addition to fairness arguments, proponents argue for continued marriage penalty relief on economic efficiency grounds.

Any attempt to address the marriage tax penalty involves the balancing of several competing principles, including equal tax treatment of married couples with equal incomes, the determination of equitable relative tax burdens of single individuals and married couples with equal incomes, the degree of progressivity of the tax system, and the goal of simplicity in compliance and administration. It is not possible to have a tax system that has a progressive rate structure, taxes married couples with equal incomes equally, and is neutral with respect to marriage. Opponents of the extension argue that it goes too far in creating marriage bonuses while attempting to alleviate marriage penalties, and imposes too high a relative tax burden on single individuals.

Earned income tax credit

Large marriage penalties exist in the EITC, because the parameters of the credit are based on earned income and numbers of qualifying children and not on marital status (other than the one provision that delays the phase-out of the credit for married taxpayers). Proponents argue that extending the EGTRRA provisions are necessary for two reasons. First, they argue that the reduction in the marriage penalty for EITC filers is particularly important for this low-income

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[25] As a single taxpayer, the man could claim the standard deduction of $5,700 and one personal exemption of $3,650 for 2010, effectively exempting the first $9,350 of his earnings. This example ignores payroll taxes.

[26] This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 28 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 28-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 28 percent to 15 percent.

[27] For a general discussion of legislative history and economic issues with respect to marriage penalty issues see Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to the Marriage Tax Penalty, the Child Tax Credit, and the Alternative Minimum Tax* (JCX-8-01), March 7, 2001. See Congressional Budget Office, *For Better or for Worse: Marriage and the Federal Income Tax*, June 1997, pp. 10-12, for a review of economic literature regarding labor supply issues with respect to the marriage penalty.

population, such that credit recipients are not discouraged from marrying on account of the loss or reduction in credit that marriage could entail. Second, they believe the simplification provisions have been effective and are worth maintaining. Others respond that simplification proposals should be addressed as part of a more comprehensive reform of the credit to reduce or eliminate high error rates by tax filers.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009 and 2010 budget proposals.

G. Education Incentives

Present Law

Income and wage exclusion for awards under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income under section 117 are also excludable from wages for payroll tax purposes.[28]

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program").

The NHSC Scholarship Program and the Armed Forces Scholarship Program provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Under the sunset provisions of EGTRRA, the exclusion from gross income and wages for the NHSC Scholarship Program and the Armed Forces Scholarship Program will no longer apply for taxable years beginning after December 31, 2010.

Income and wage exclusion for employer-provided educational assistance

If certain requirements are satisfied, up to $5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax

[28] Sec. 3121(a)(20).

purposes and from wages for employment tax purposes.[29] This exclusion applies to both graduate and undergraduate courses.[30] For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include (1) tools or supplies that may be retained by the employee after completion of a course, (2) meals, lodging, or transportation, or (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (e.g., it does not apply to education provided to the spouse or a child of the employee).

In the absence of the specific exclusion for employer-provided educational assistance under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit.[31] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

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[29] Secs. 127, 3121(a)(18).

[30] The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA, although that change does not apply to taxable years beginning after December 31, 2010 (under EGTRRA's sunset provision).

[31] Sec. 132(d).

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended 10 times.[32] EGTRRA deleted the exclusion's explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.[33]

Deduction for student loan interest

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.[34] Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending an eligible educational institution on at least a half-time basis. Eligible educational institutions are (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Additionally, to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

The maximum allowable deduction per year is $2,500. For 2010, the deduction is phased out ratably for single taxpayers with AGI between $60,000 and $75,000 and between $120,000 and $150,000 for married taxpayers filing a joint return. The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of $5,000.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire are: (1) increases that were made in the AGI phaseout ranges for the deduction and (2) rules that extended deductibility of interest beyond the first 60 months that interest payments are required. With the expiration of EGTRRA, the phaseout ranges will revert to a base level of

[32] The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date).

[33] Treas. Reg. sec. 1.162-5.

[34] Sec. 221.

$40,000 to $55,000 ($60,000 to $75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

Coverdell education savings accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.[35] Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.[36] However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[37]

Tax-free (including free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include "qualified higher education expenses" and "qualified elementary and secondary education expenses."

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible

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[35] Sec. 530.

[36] In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

[37] This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

educational institution on a full-time, half-time, or less than half-time basis.[38] Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.[39]

The term "qualified elementary and secondary education expenses," means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary education expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee's gross income under section 127.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire are: (1) the increase in the contribution limit to $2,000 from $500; (2) the increase in the phaseout range for married taxpayers filing jointly to $190,000-$220,000 from $150,000-$160,000; (3) the expansion of qualified expenses to include elementary and secondary education expenses; (4) special age rules for special needs beneficiaries; (5) clarification that corporations and other entities are permitted to make contributions, regardless of the income of the corporation or entity during the year of the contribution; (6) certain rules regarding when contributions are deemed made and extending the time during which excess contributions may be returned without additional tax; (7) certain rules regarding coordination with the Hope and

[38] Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

[39] Sec. 530(b)(2)(B).

Lifetime Learning credits; and (8) certain rules regarding coordination with qualified tuition programs.

Amount of governmental bonds that may be issued by governments qualifying for the "small governmental unit" arbitrage rebate exception

To prevent State and local governments from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds.[40] The Code also provides certain exceptions to the arbitrage restrictions. Under one such exception, small issuers of governmental bonds issued for local governmental activities are not subject to the rebate requirement.[41] To qualify for this exception the governmental bonds must be issued by a governmental unit with general taxing powers that reasonably expects to issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[42] Prior to EGTRRA, the $5 million limit was increased to $10 million if at least $5 million of the bonds are used to finance public schools. EGTRRA provided the additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from $5 million to $10 million.[43] Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures. This increase is subject to the EGTRRA sunset.

Issuance of tax-exempt private activity bonds for public school facilities

Interest on bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue act. These bonds are called "private activity bonds."[44] The term "private person" includes the Federal government and all other individuals and entities other than State or local governments.

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[40] The exclusion from gross income for interest on State and local bonds does not apply to any arbitrage bond (sec. 103(a), (b)(2)). A bond is an arbitrage bond if it is part of an issue that violates the restrictions against investing in higher-yielding investments under section 148(a) or that fails to satisfy the requirement to rebate arbitrage earnings under section 148(f).

[41] Ninety-five percent or more of the net proceeds of governmental bond issue are to be used for local governmental activities of the issuer. Sec. 148(f)(4)(D).

[42] Under the Treasury regulations, an issuer may apply a fact-based rather than an expectations-based test. Treas. Reg. 1.148-8(c)(1).

[43] Sec. 148(f)(4)(D)(vii).

[44] The Code provides that the exclusion from gross income does not apply to interest on private activity bonds that are not qualified bonds within the meaning of section 141. See secs. 103(b)(1), 141.

Only specified private activity bonds are tax-exempt. EGTRRA added a new type of private activity bond that is subject to the EGTRRA sunset. This category is bonds for elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency.[45] The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes, or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-State private activity bond volume limit equal to $10 per resident ($5 million, if greater) in lieu of the present-law State private activity bond volume limits. As with the present-law State private activity bond volume limits, States can decide how to allocate the bond authority to State and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present-law private activity bond volume limits.

Description of Proposal

The proposal repeals the EGTRRA sunset as it applies to the NHSC Scholarship Program and the Armed Forces Scholarship Program, the section 127 exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, and Coverdell education savings accounts. The proposal also repeals the EGTRRA sunset as it applies to the expansion of the small government unit exception to arbitrage rebate and allowing issuance of tax-exempt private activity bonds for public school facilities. Thus, all of these tax benefits for education continue to be available after 2010.

Effective date.–The proposal is effective on the date of enactment.

Analysis

Individual benefits

The present-law education tax benefits for individuals that are scheduled to expire under the EGTRRA sunset provision are intended to provide taxpayers with some financial relief for education expenses previously incurred (the modifications to the deduction for student loan interest), for current education expenses (the income and wage exclusion for awards under the

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[45] Sec. 142(a)(13), (k).

NHSC Scholarship Program and the Armed Forces Scholarship Program and the income and wage exclusion for employer-provided educational assistance), and for future education expenses (the modifications to Coverdell education savings accounts). If these provisions are not extended, some of the tax benefits will be completely eliminated (the income and wage exclusion for awards under the NHSC Scholarship Program and the Armed Forces Scholarship Program and the income and wage exclusion for employer-provided educational assistance), while the others will be substantially narrowed (the modifications to the deduction for student loan interest and to Coverdell education savings accounts).

Some people may observe that permanently extending these provisions may lessen the financial burden of obtaining an education for a number of taxpayers. These people may further argue that there is a distinct government interest in having a well-educated populace in the United States, and, as such, it is important for the government to continue programs that encourage the development of such a populace. Other people may observe that there are already substantial nontax incentives to obtaining additional education (e.g., greater lifetime earning potential and increased job opportunities), and these incentives are sufficient to encourage individuals to obtain an appropriate level of education.

An additional argument that some people may make is that permanently extending these provisions will remove from the Code some of the considerable uncertainty inherent in provisions with a temporary existence, which may or may not be extended at some future date. In this particular case, this uncertainty may make it difficult for taxpayers to make optimal decisions today as to the total amount that they should spend on education since they cannot be certain whether tax benefits that may currently be available to them will be available to them in the future, after they have committed themselves to pursuing additional education. As a result, they may overinvest in education, on the assumption that tax benefits will be extended when, ultimately, they are not, or underinvest in education, on the assumption that tax benefits will not be extended when, ultimately, they are. One possible response to this argument is that Congress is aware of the potential for this type of uncertainty whenever it enacts temporary provisions and deems it acceptable for any of a number of possible reasons. For example, Congress may want to revisit the issue in the future, may have insufficient support for a permanent provision, or may feel that a permanent provision is too costly. A second possible response to the argument above is that permanently extending present law is not the only way to achieve certainty; certainty may also be achieved by letting the temporary provisions expire or by enacting a permanent law today that provides for something other than a mere extension of present law.

Bonds for public school facilities

The policy underlying the arbitrage rebate exception for bonds of small governmental units is to reduce complexity for these entities because they may not have in-house financial staff to engage in the expenditure and investment tracking necessary for rebate compliance. It is argued that the exception further is justified by the limited potential for arbitrage profits at small issuance levels and limitation of the provision to governmental bonds, which typically require voter approval before issuance. Opponents respond that issuers have sufficient financial sophistication that the exceptions are unwarranted.

Proponents of public-private partnerships to improve educational opportunities argue that the new category of private activity bonds allows public-private partnerships to reap the benefit of the implicit subsidy to capital costs provided through tax-exempt financing. Opponents may respond that expansions of allowable private activity bonds can lead to increased borrowing costs for all private activity bonds.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009, and 2010 budget proposals.

H. Modify and Make Permanent the Estate, Gift, and Generation Skipping Transfer Taxes After 2009

Present and Prior Law

In general

In general, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

The estate and generation skipping transfers taxes are repealed for decedents dying and gifts made during 2010, but are reinstated for decedents dying and gifts made after 2010.

Exemption equivalent amounts and applicable tax rates

In general

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death.[46] The unified credit offsets tax computed at the lowest estate and gift tax rates.

Before 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continued to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes was higher than the effective exemption amount allowed for gift tax purposes. In 2009, the highest estate and gift tax rate was 45 percent. The unified credit effective exemption amount was $3.5 million for estate tax purposes and $1 million for gift tax purposes.

For 2009 and after 2010, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to and after repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

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[46] Sec. 2010.

Repeal of estate and generation skipping transfer taxes in 2010; modifications to gift tax

Under EGTRRA, the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a $1 million exemption amount and a gift tax rate of 35 percent. Also in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Reinstatement of the estate and generation skipping transfer taxes for decedents dying and generation skipping transfers made after December 31, 2010

The estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted will apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of $1 million indexed for inflation for generation skipping transfer tax purposes will apply for purposes of determining the tax on cumulative taxable transfers by lifetime gift or bequest.

Basis in property received

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property.[47] Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Property received from a donor of a lifetime gift generally takes a carryover basis.[48] "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of

[47] Sec. 1001.

[48] Sec. 1015.

property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of the gift.

Basis in property received from a decedent who died in 2009

Property passing from a decedent who died during 2009 generally takes a "stepped-up" basis.[49] In other words, the basis of property passing from such a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up in basis generally eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death was less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.[50]

Basis in property received from a decedent who dies during 2010

The rules providing for date-of-death fair market value ("stepped-up") basis in property acquired from a decedent are repealed for assets acquired from decedents dying in 2010, and a modified carryover basis regime applies.[51] Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

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[49] Sec. 1014.

[50] There is an exception to the rule that assets subject to the Federal estate tax receive stepped-up basis in the case of "income in respect of a decedent." Sec. 1014(c). The basis of assets that are "income in respect of a decedent" is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it was in the hands of the decedent) increased by estate tax paid on that asset. Income in respect of a decedent includes rights to income that has been earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by section 401(k).

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under 2009 law, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

[51] Sec. 1022.

An executor generally may increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse may be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses generally may be increased by up to $4.3 million. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to $60,000.

Repeal of modified carryover basis regime for determining basis in property received from a decedent who dies after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. Instead, the law in effect prior to 2010, which generally provides for date-of-death fair market value ("stepped-up") basis in property passing from a decedent, will apply.

State death tax credit; deduction for State death taxes paid

State death tax credit under prior law

Before 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate.[52] The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which served to impose a State tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.[53] Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability

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[52] Sec. 2011.

[53] Sec. 2058.

becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Reinstatement of State death tax credit for decedents dying after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect for decedents who died prior to 2002 will apply.

Exclusions and deductions

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of $13,000 (for 2010) on transfers of present interests in property to any one donee during the taxable year.[54] If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $26,000 for 2010. The dollar amounts are indexed for inflation.

Transfers to a surviving spouse

In general.−A 100-percent marital deduction generally is permitted for estate and gift tax purposes for the value of property transferred between spouses.[55] In addition, transfers of "qualified terminable interest property" also are eligible for the marital deduction. "Qualified terminable interest property" is property: (1) that passes from the decedent; (2) in which the surviving spouse has a "qualifying income interest for life"; and (3) to which an election applies. A "qualifying income interest for life" exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life; and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse to be effective during the life of the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens.−A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States.[56] A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from

[54] Sec. 2503(b).

[55] Secs. 2056 & 2523.

[56] Secs. 2056(d)(1) and 2523(i)(1).

a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

For years when the estate tax is in effect, there is an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Conservation easements

For years when an estate tax is in effect, an executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $500,000.[57] The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Before 2001, a qualified conservation easement generally was one that met the following requirements: (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expanded the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance of a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modifications to expand the availability of qualified conservation contributions do not apply for decedents dying after December 31, 2010.

[57] Sec. 2031(c).

Provisions affecting small and family-owned businesses and farms

Special-use valuation

For years when an estate tax is in effect, an executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.[58] The maximum reduction in value for such real property was $1 million for 2009. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years immediately preceding the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to $675,000.[59] A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns, in the case of the 70-percent and 90-percent rules, at least 30 percent of the trade or business.

To qualify for the deduction, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

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[58] Sec. 2032A.

[59] Sec. 2057. The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. Because of the coordination between the qualified family-owned business deduction and the unified credit effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds $1.3 million.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the qualified family-owned business deduction will apply to estates of decedents dying after December 31, 2010.

Installment payment of estate tax for closely held businesses

Estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).[60] An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1.34 million[61] (as adjusted annually for inflation occurring after 1998; the original amount for 1998 was $1 million) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1.34 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was: (1) an interest as a proprietor in a sole proprietorship; (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners; and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and pre-EGTRRA law, the decedent may own the interest directly or, in certain cases, indirectly through a holding company. If ownership is through a holding company,

[60] Sec. 6166.

[61] Rev. Proc. 2009-50, I.R.B. 2009-45 (Nov. 9, 2009).

the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010.

Generation-skipping transfer tax rules

In general

For years before and after 2010, a generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (as defined above).[62] Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.[63] An exemption generally equal to the estate tax

[62] Sec. 2601.

[63] Sec. 2611.

exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person.[64] Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.[65] A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).[66] If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation skipping transfer indicates the amount of "generation skipping transfer tax exemption" allocated to a trust. The allocation of generation skipping transfer tax exemption effectively reduces the tax rate on a generation skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

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[64] Sec. 2612(c).

[65] Sec. 2612(a).

[66] Sec. 2612(b).

Modifications to the generation skipping transfer tax rules under EGTRRA

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a "qualified severance." A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation skipping transfer tax exemption allocation, and the relief would be retroactive to the date of the transfer.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

Sunset of EGTRRA modifications to the generation skipping transfer tax rules

As described above, the estate and generation skipping transfer taxes are repealed for decedents dying and gifts made in 2010. The estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the generation skipping transfer tax again will apply after December 31, 2010. However, the EGTRRA modifications to the generation skipping transfer tax rules described above will not apply to generation skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to 2001 will apply.

Description of Proposal

The proposal generally makes permanent the estate, gift, and generation skipping transfer tax laws in effect for 2009, retroactive to the beginning of 2010. Under the proposal, the applicable exclusion amount for estate tax purposes generally is $3.5 million for decedents dying during 2010 and later years. The applicable exclusion amount for gift tax purposes is $1 million for 2010 and later years. The highest estate and gift tax rate under the proposal is 45 percent, as under 2009 law.[67]

As under present law, the generation skipping transfer tax exemption for a given year is equal to the applicable exclusion amount for estate tax purposes ($3.5 million for 2010 and later years), and the generation skipping transfer tax rate for a given year will be determined using the highest estate tax rate in effect for such year.

The proposal makes permanent the repeal of the State death tax credit; as under 2009 law, the proposal allows a deduction for certain death taxes paid to any State or the District of Columbia. In addition, the proposal makes permanent the repeal of the qualified family-owned business deduction.

The proposal also repeals the modified carryover basis rules that, under EGTRRA, would apply for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the proposal, a recipient of property acquired from a decedent who dies after December 31, 2009, generally will receive date-of-death fair market value basis (i.e., "stepped up" basis) under the basis rules that applied to assets acquired from decedents who died in 2009.

Under the proposal, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions scheduled to occur at the end of 2010, is repealed. As a result, the proposal makes permanent the above-described EGTRRA modifications to the rules regarding

[67] As under present law, the tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the tax rate schedule in effect for that year had been in effect on the date of the prior-year gifts.

(1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the generation skipping transfer tax.

Effective date.−The proposal is effective for estates of decedents dying, generation skipping transfers made, and gifts made after December 31, 2009.

Analysis

Transfer tax planning issues

Stability and consistency in the law

As described above, under EGTRRA the estate tax exemption amount and the estate and gift tax rates changed on an almost annual basis between 2002 and 2009. The estate and generation skipping taxes are repealed temporarily in 2010, followed by reinstatement of the taxes in 2011 with a lower exemption amount and a higher top marginal tax rate. Present law provides for two distinct sets of rules for determining basis of assets received from a decedent, depending on whether the decedent dies in 2010 or in a different year. The credit for succession taxes paid to a State was phased out and replaced with a deduction. In addition, increases in the estate tax exemption amount resulted in a phase-out and effective repeal of the deduction for qualified family-owned business interests under section 2057, but section 2057 again will be operative for 2011 and later years. Certain other modifications to the estate and gift tax laws under EGTRRA are scheduled to expire at the end of 2010.

Commentators have advocated a stable and more predictable estate and gift tax system -- without constantly changing parameters, phase-outs, or sunsets -- arguing that the complexity of current law has made estate planning difficult and costly. The American Bar Association's Task Force on Federal Wealth Transfer Taxes argued that, because of the complexity of current law, "[a] significant number of individuals likely will have estate plans with provisions that are inappropriate."[68] This could arise, for example, because estate planners fail to plan properly for changes in law, taxpayers are reluctant to incur the transaction costs associated with repeatedly modifying estate plans, or taxpayers choose to delay further planning in the hope that they will not die before the estate tax is permanently repealed or substantially reduced. As another example, the ABA Task Force notes that some taxpayers wish to maintain life insurance only if they will have an estate tax liability, but this is difficult to determine when the estate tax laws are unsettled and changing.[69]

Differences in estate and gift tax exemption amounts

Under the budget proposal, the gift tax exemption amount remains $1 million, while the estate tax exemption amount is $3.5 million. Commentators have argued that this decoupling of

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[68] American Bar Association, Task Force on Federal Wealth Transfer Taxes, "Report on Reform of Federal Wealth Transfer Taxes" (2004) (hereinafter "ABA Task Force"), p. 3.

[69] *Ibid*., pp. 3-5.

the estate and gift tax exemption amounts complicates wealth transfer tax planning and raises administrability issues, and that the exemption amounts, therefore, should be reunified.

For example, some commentators argue that, as a result of the lower gift tax exemption amount, taxpayers are likely to engage in complicated and costly planning to avoid gift tax.[70] They argue that the lower gift tax exemption (and resulting higher cost of the gift tax) could encourage taxpayers to create complicated long-term trusts at death designed to avoid gift tax on transfers to successive generations. They further argue that the lower gift tax exemption will encourage taxpayers to delay transfers until death, "encouraging family wealth to remain 'locked in' older generations."[71]

The extent to which such practices have increased in use since the exemption amounts were decoupled in 2004 is uncertain. In addition, the effect of the lower gift tax exemption amount from 2004 through 2009 is partially mitigated by a structural difference between the estate tax and the gift tax that generally benefits taxpayers who make inter vivos gifts: the gift tax is "tax exclusive," whereas the estate tax is "tax inclusive." In other words, under the estate tax, the assets used to pay the tax are included in the estate tax base. Thus, if the estate and gift taxes were fully reunified, the gift tax would be a less costly tax.

Furthermore, the gift tax often is viewed as being necessary to protect the income tax base. In the absence of a gift tax, it may be possible for a taxpayer to transfer an asset with built-in gain or that produces income to a taxpayer who is in a lower tax bracket, where the gain or income would be realized and taxed at a lower rate before the asset is gifted back to the original holder. Therefore, if the gift tax effective exemption amount were increased to equal the higher estate tax exemption amount, the effectiveness of the gift tax as a tool to protect the income tax base may be diminished.

<u>Treatment of State death taxes for Federal estate tax purposes</u>

Prior to 2002, Federal law allowed for a credit against the Federal estate tax for any estate, inheritance, legacy or succession taxes (referred to as "State death taxes") actually paid to any State or the District of Columbia.[72] The credit was determined under a graduated rate table set forth in section 2011(b), which ties the maximum credit amount to the "adjusted taxable estate," which is the taxable estate reduced by $60,000. Under EGTRRA, the amount of the allowable credit was reduced from 2002 through 2004. For decedents dying after 2004, the credit is replaced with a deduction from the gross estate for State death taxes actually paid to any State or the District of Columbia.[73] The budget proposal reinstates and makes permanent the State death tax deduction.

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[70] *Ibid.*, p. 22.

[71] *Ibid.*, pp. 22-23.

[72] Sec. 2011.

[73] Sec. 2058.

Before the credit was repealed, many States imposed "soak-up" or "pick-up" taxes, *i.e.*, State taxes designed to impose a tax equal to the maximum amount of the Federal credit allowed to a decedent. Such taxes had the effect of shifting revenue to States from the Federal government, without changing the overall amount of estate tax liability (Federal and State) of a taxpayer. Under prior law, all of the States imposed a tax at a level at least equal to the amount of the State death tax credit allowed under section 2011.[74] As of July 1, 2009, however, 27 States imposed no State death taxes.[75]

Some argue that the State death tax credit should be reinstated rather than retaining the present-law deduction. They argue, for example, that the credit served as a powerful funding mechanism for States; because States are struggling financially in the current economy, the States are in critical need of such funding. Furthermore, because it is politically difficult to enact new taxes in many States, some State legislatures have been unable or unwilling to replace existing soak-up taxes (which in some cases now lie dormant because such laws operate only to the extent Federal law allows a credit for State death taxes) with new estate or inheritance taxes, leaving such States without an annual stream of revenue. Some advocates of reinstating the State death tax credit also argue that the absence of Federal credit increases the disparity in estate taxes imposed by the various States, which can (1) lead to competition between States to attract wealthy residents and (2) result in disparate tax treatment of similarly situated individuals, depending only on an individual's State of residence at the time of death.[76]

Others argue that the State death tax credit should not be reinstated. Some argue, for example, that estate or other succession taxes, whether Federal or State, are undesirable and that the allowance of a Federal credit for State death taxes is a subsidy to States that encourages the enactment or retention of State-level death taxes. Some might also argue that if the intended policy is to provide a funding mechanism for State governments, it would be more direct and efficient to provide a direct Federal government subsidy instead of making a tax expenditure through the tax system.

Federal estate tax and basis of transferred assets

Present law includes two sets of rules for determining the basis of property acquired from a decedent's estate. The basis of property acquired from estates of decedents dying anytime before or after 2010 generally is the property's fair market value at the time of the decedent's death. As a result of this basis step-up (or step-down if property declined in value while owned by the decedent) when a taxpayer sells inherited property, the taxpayer generally does not recognize gain or loss attributable to appreciation or depreciation in the property that occurred during the decedent's holding period. Present law provides a different rule for property acquired from estates of decedents dying in 2010. For this property, there is no Federal estate tax, but

[74] ABA Task Force, p. 8.

[75] See McGuire Woods LLP, 2009 State Death Tax Chart (Revised July 1, 2009), available at *http://mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf*.

[76] See, e.g., Jeffrey A. Cooper, "Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective," 33 *Pepperdine Law Review* 835 (2006).

heirs generally take a carryover basis. This carryover basis preserves in the hands of an heir taxable gain or loss attributable to increases or decreases in the value of property during the decedent's holding period. The one-year change from an estate tax coupled with basis step-up (or step-down) to estate tax repeal with carryover basis raises several behavioral and administrative issues. A few significant issues are described below.

Carryover basis may affect a taxpayer's willingness to sell an appreciated asset. In general, a realization-based tax system creates "lock-in," a behavioral distortion that may be described as the reluctance of an individual to sell property and thereby incur tax on the recognition of accrued appreciation in the property. This lock-in reduces the mobility of capital to potentially higher return investments. Proponents of carryover basis argue that allowing inherited property to receive a basis step-up accentuates lock-in. Because income taxes on accrued appreciation can be avoided entirely if the basis of property that passes at death is stepped up to its fair market value at the time of death, an individual may choose not to sell appreciated property before death. Under this argument, carryover basis would reduce lock-in because holding assets until death would not permit avoidance of income tax liability on pre-death appreciation when assets eventually are sold by heirs. Conversely, opponents of carryover basis argue that it perpetuates lock-in because income tax liability for pre-death gains carries over to the heir. Thus, under carryover basis the decedent's beneficiary also may refrain from selling an asset because of the adverse income tax consequences from sale. Opponents of carryover basis argue that the stepped-up basis rule removes the lock-in effect once each generation.

Under carryover basis, taxpayers will be required to establish a decedent's historical cost basis in inherited assets. Commentators have argued that establishing this historical cost basis may be difficult in many cases.[77] The difficulty may be acute in part because the decedent is no longer available to remember the history of assets and where records of transactions affecting basis might be located. This problem may be especially troublesome in the case of personal residences for which there may be many transactions that affect basis; personal effects such as jewelry; assets such as classic cars that appreciate in value and to which many improvements may be made; and unique assets such as paintings and stamp collections. It may be possible to use presumptions to ameliorate the difficulty of establishing historical cost basis. For example, a rule that presumed the decedent purchased an asset at its value on the date of its acquisition would in some cases limit the necessary knowledge to the date the decedent acquired the asset. In the absence of statutory presumptions, if an heir is unable to establish a decedent's basis in property, a question is whether the IRS will consider the heir to have a zero basis in the property.

[77] Nonna A. Noto, "Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal," CRS Report for Congress RL30875, p. 9 (updated Apr. 20, 2001). The report notes that practitioners raised this concern when a previous attempt to institute carryover basis was enacted (and repealed before taking effect) by the Tax Reform Act of 1976. See also AICPA Tax Division, "Reform of the Estate and Gift Tax System," *Tax Notes* (Apr. 9, 2001), p. 322.

A related issue under a carryover basis regime is the role of the executor of an estate in determining the decedent's basis in the assets over which the executor has control.[78] When carryover basis rules were adopted in 1976, the executor was required to obtain information about basis and to provide that information to heirs. No such requirement was included in the carryover basis rules adopted in 2001. If rules required executors to provide basis information to beneficiaries or if executors provided information in the absence of a requirement, a question would be whether beneficiaries would be permitted to rely on the information and whether executors would be subject to penalties for failure to report correct or complete information. Although the 2001 rules do not require an executor to provide basis information to beneficiaries, they do provide that an executor must allocate the permitted basis increases (the $1.3 million and $3 million amounts described previously) among estate assets, and they permit broad discretion in making the allocation (subject to a prohibition on using basis additions to create a built-in loss in any single asset). This broad discretion may create difficulties for executors concerned about fiduciary obligations and may create uncertainty for beneficiaries if an executor fails to make an allocation.

Change from a step-up basis rule to a carryover basis regime raises a question whether the change should be accompanied by transition rules. Some individuals may have purchased and held appreciating or depreciable property with the expectation that the basis of the property would be stepped-up upon the individuals' deaths. These individuals may argue that it would be unfair to repeal the stepped-up basis rule at least with respect to amounts of appreciation that have occurred before the time of the rule change. The carryover basis rules adopted in 1976 provided a grandfather rule under which the basis of an inherited asset could not be less than its value on December 31, 1976. Establishing the value of all assets that could be inherited proved to be a difficult and time consuming exercise. EGTRRA's carryover basis rules do not provide a grandfather for pre-carryover basis appreciation.

<u>Retroactive application of the estate and generation skipping transfer taxes</u>

The proposal makes permanent the estate, gift and generation skipping tax laws that were in effect in 2009, effective for decedents dying and gifts made after December 31, 2009. The estate and generation skipping taxes thus would be reinstated for all estates of decedents dying and gifts made during 2010, even with respect to transfers that occurred prior to the enactment of the proposal. Similarly, the modified carryover basis rules for assets acquired from a decedent who dies in 2010 would be repealed retroactively and replaced with the 2009 step-up in basis rules.

Some may argue that retroactive imposition of the estate and generation skipping taxes is inappropriate, because such retroactivity may be unconstitutional or is simply unfair. Although the outcome of any constitutional challenge is uncertain, some believe that a constitutional challenge itself is a virtual certainty, "calling the tax law into question while litigation and

[78] AICPA Tax Division, supra note 82, p. 326; Task Force on Federal Wealth Transfer Tax, Report on Reform of Federal Wealth Transfer Taxes 72 (2004); Karen C. Burke and Grayson M.P. McCouch, "Estate Tax Repeal: Through the Looking Glass," 22 *Virginia Tax Review* 187, 220 (2002).

appeals, maybe all the way to the Supreme Court, are ongoing."[79] In other words, the likelihood of litigation, even if ultimately unsuccessful, could result in years of uncertainty for taxpayers, heirs, and fiduciaries.

With regard to fairness, some may argue that taxpayers rely on the law that is in effect when planning wealth transfers, and that it is inappropriate for Congress to change the applicable rules after the fact. A taxpayer, for example, may choose to make an outright gift to a great-grandchild in early 2010, when there is no generation skipping transfer tax. Had the taxpayer known that the generation skipping transfer tax would apply to the transfer, it is possible that he or she would not have made the outright gift or would have structured the gift in a different way.

On the other hand, some may argue that retroactive application of the 2009 transfer tax and basis rules is both appropriate and fair. First, lawmakers widely discussed the prospect of retroactivity prior to the end of 2009, such that taxpayers and estate planners had some prior knowledge that the transfer tax and basis rules could be retroactively modified. Furthermore, some may argue that a greater number of taxpayers will be affected negatively by the law currently in effect for 2010; in other words, a smaller number of taxpayers would face an increased tax liability if the 2009 rules were extended retroactively. Specifically, under 2010 law, assets acquired from a decedent do not receive a full step up in basis. As a result, many heirs will incur capital gains tax liability upon a sale or other disposition of an inherited asset. If the 2009 rules instead applied, the same asset would receive a full step up in basis as of the decedent's death, such that the heir would not incur capital gains tax liability upon a subsequent disposition of the asset with respect to appreciation that occurred before the decedent's death. The number of heirs who have the potential for greater capital gains tax liability under 2010 law likely far exceeds the number of decedents' estates that will benefit from the absence of an estate tax under 2010 law.

Economic issues

Wealth taxes, saving, and investment

Some may argue that a reduction in the estate tax for years after 2010, as under the proposal, would affect taxpayers' saving and investment behavior. Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. In particular, there is no consensus among economists on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run. A related issue is to what extent individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their saving. Again, there is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.

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[79] Ronald D. Aucutt, Milford B. Hatcher, Jr., Charles D. Fox IV, and Diana S.C. Zeydel, "The Impact of Estate Tax Repeal -- Going Blindly Where No One Else Has Gone," American Law Institute - American Bar Association Continuing Legal Education (Feb. 18-20, 2010).

Some economists believe that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs.[80] It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.[81] Others believe the bequest motive is not important in national capital formation,[82] and empirical analysis of the existence of a bequest motive has not led to a consensus.[83] Theoretically, it is an open question whether estate and gift taxes encourage or discourage saving, and there has been limited empirical analysis of this specific issue.[84] By

[80] A discussion of why, theoretically, the effect of the estate tax on saving behavior depends upon taxpayers' motives for intergenerational transfers and wealth accumulation is provided by William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in William G. Gale and Joel B. Slemrod, eds., *Rethinking the Estate Tax*, (Washington, D.C: The Brookings Institution), 2001. For a brief review of how different views of the bequest motive may alter taxpayer bequest behavior, see William G. Gale and Joel B. Slemrod, "Death Watch for the Estate Tax," *Journal of Economic Perspectives*, 15, Winter, 2001, pp. 205-218.

[81] See Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, 89, August, 1981. Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, 2, Spring, 1988. For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, 45, June, 1992. For attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Kreuger (eds.), *The Political Economy of Tax Reform* (Chicago: The University of Chicago Press), 1992; and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives*, 8, Fall 1994, pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

[82] Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *Journal of Economic Perspectives*, 2, Spring, 1988. In this article, Modigliani argues that 15 percent is more likely an upper bound.

[83] See B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy*, 99, October 1991, pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, "Savings of the Elderly and Desired Bequests," *American Economic Review*, 77, June 1987, pp. 298-312. Hurd concludes that "any bequest motive is not an important determinant of consumption decisions and wealth holdings.... Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities." (p. 308).

[84] Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), 2001, use estate tax return data from 1916 to 1996 to investigate the impact of the estate tax on reported estates. They find a negative correlation between measures of the level of estate taxation and reported wealth. This finding may be consistent with the estate tax depressing wealth accumulation (depressing saving) or with the estate tax encouraging successful avoidance activity.

raising the after-tax cost of leaving a bequest, a more expansive estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation to meet that goal. For example, some individuals purchase additional life insurance to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Wealth taxes and small business

Regardless of any potential effect on aggregate saving, the scope and design of the transfer tax system may affect the composition of investment. In particular, some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned businesses. They note that if a family has a substantial proportion of its wealth invested in one enterprise, the need to pay estate taxes may force heirs to liquidate all or part of the enterprise or to encumber the business with debt to meet the estate tax liability. If the business is sold, while the assets generally do not cease to exist and remain a productive part of the economy, the share of business represented by small or family-owned businesses may be diminished by the estate tax. If the business borrows to meet estate tax liability, the business's cash flow may be strained. There is some evidence that many businesses may be constrained in the amount of funds they can borrow. If businesses are constrained, they may reduce the amount of investment in the business and this would be a market inefficiency.[85] One study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.[86]

Others argue that potential deleterious effects of the estate tax on investment by small or family-owned businesses are limited. The 2009 (and proposed) exemption value of the unified

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More recently, David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," *National Tax Journal*, 59, June 2006, pp. 253-268, examines the size of taxable estates and the structure of the estate tax and its effects on the expected rates of return to saving. While he emphasizes the sensitivity of the analysis to how individuals' expectations about future taxes are modeled he concludes that "taxable estates are ten percent smaller because of the estate tax."

[85] Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity*, 1988, pp. 141-195.

[86] Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, 102, February 1994, pp. 53-75. Holtz-Eakin, Joulfaian, and Rosen study the effect of receipt of an inheritance on whether an entrepreneur's business survives rather than whether an on-going business that is taxed as an asset in an individual's estate survives. They find that "the effect of inheritance on the probability of surviving as an entrepreneur is small but noticeable: a $150,000 inheritance raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises do survive, inheritances have a substantial impact on their performance: the $150,000 inheritance ... is associated with a nearly 20-percent increase in an enterprise's receipts" (p.74).

These results do not necessarily imply that the aggregate economy is made better off by receipt of inheritances. Survival of the entrepreneur may not be the most highly valued investment that could be made with the funds received. For example, Francisco Perez-Gonzalez, "Inherited Control and Firm Performance," *American Economic Review*, 96, December 2006, pp. 1559-1589, finds that where the incoming CEO is related to the departing CEO, or to a founder, the firm underperforms in terms of profitability and other financial measures.

credit is \$3.5 million per decedent. As a result, small business owners can obtain an effective exemption of up to \$7.0 million per married couple, and other legitimate tax planning can further reduce the burden on such enterprises. Also, as described above, Code sections 2031A, 2057,[87] and 6166 are provided to reduce the impingement on small business cash flow that may result from an estate tax liability. Some analysis questions whether, in practice, small businesses need to liquidate operating assets to meet estate tax liabilities. A recent study of 2001 estate returns shows that many estates that claimed benefits under sections 2032A, 2057, or 6166 held liquid assets nearly sufficient to meet all debts against the estate. The study found only 2.4 percent of estates that reported closely held business assets and agricultural assets elected the deferral of tax under section 6166.[88] Others have argued that estate tax returns report a small fraction of the value of decedents' estates thereby mitigating any special burden that the estate tax may impose on small business.[89]

Wealth taxes and labor supply

As people become wealthier, they have an incentive to consume more of everything, including leisure time. Some, therefore, suggest that, by reducing the amount of wealth transferrable to heirs, transfer taxes may reduce labor supply of the parent, although it may increase labor supply of the heir. Over 100 years ago, Andrew Carnegie opined that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would . . . ."[90] While, in

[87] As discussed above, section 2057 no longer applies for estates of decedents dying after 2003, but will apply to estates of decedents dying after 2010.

[88] Martha Eller Gangi and Brian G. Raub, "Utilization of Special Estate Tax Provisions for Family-Owned Farms and Closely Held Businesses," *SOI Bulletin*, 26, Summer 2006, pp. 128-145. Gangi and Raub calculate a liquidity ratio, the ratio of liquid assets (cash, cash management accounts, State and local bonds, Federal government bonds, publicly traded stock, and insurance on the life of the decedent) to the sum of the net estate tax plus mortgages and liens. They found that in 2001 this ratio exceeded one for estates of less than \$2.5 million claiming benefits of the special deduction for qualified family owned business assets or deferral of tax. Larger such estates had average liquidity ratios of 0.5 or more. Generally all estates claiming special use valuations had an average liquidity ratio of at least one. A liquidity ratio of one implies that the estate has liquid assets sufficient to pay the net estate tax plus pay off all mortgages and liens.

[89] See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Tax Avoidance*, (Washington, D.C.: The Brookings Institution), 1979. Also, see B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in Lawrence H. Summers (ed.), *Tax Policy and the Economy* 1 (Cambridge, Mass.: The MIT Press), 1987; and Alicia H. Munnell with Nicole Ernsberger, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, November/December 1988. These studies pre-date the enactment of chapter 14 of the Code. The purpose of chapter 14 is to improve reporting of asset values in certain transfers. Nevertheless, planning opportunities remain whereby small business owners can reduce the cash required to meet an estate tax obligation, see Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05, January 27, 2005. The Joint Committee staff discusses the ability to use valuation discounts and lapsing trust powers effectively to shelter business (and other) assets from the estate tax on pages 396-408.

[90] Andrew Carnegie, "The Advantages of Poverty," in *The Gospel of Wealth and Other Timely Essays,* Edward C. Kirkland (ed.), (Cambridge, MA: The Belknap Press of Harvard University Press), 1962, reprint of Carnegie from 1891.

theory, increases in wealth should reduce labor supply, empirically economists have found the magnitude of these effects to be small.[91]

Conversely, by reducing the amount of wealth transferrable to heirs, the estate tax could increase work effort of heirs as the benefits of the installment payment method, special-use valuation, and the exclusion for qualified family-owned business interests will be lost and recaptured if the assets fail to remain in a qualified use. In addition, the estate tax also could distort, in either direction, the labor supply of the transferor if it distorts his or her decision to make a bequest.

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, Federal transfer taxes may help prevent an increase in the concentration of wealth. Overall, there are relatively few analyses of the distribution of wealth holdings in the economic literature.[92] Conventional economic wisdom holds that the Great Depression of the 1930s and World War II substantially reduced the concentration of wealth in the United States, and that there had been no substantial change at least through the 1980s. Most analysts assign no role to tax policy in the reduction in wealth concentration that occurred between 1930 and 1945. Nor has any analyst been able to quantify what role tax policy might have played since World War II.[93]

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[91] For a review of this issue, see John Pencavel, "Labor Supply of Men: A Survey," in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, vol. I, (New York, NY: North-Holland Publishing Co.) 1986. For a direct empirical test of what some refer to as the "Carnegie Conjecture," see Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, 108, May 1993, pp. 413-435. Holtz-Eakin, Joulfaian, and Rosen assess the labor force participation of families that receive an inheritance. They find that "the likelihood that a person decreases his or her participation in the labor force increases with the size of the inheritance received. For example, families with one or two earners who received inheritances above $150,000 [in 1982-1985 constant dollars] were about three times more likely to reduce their labor force participation to zero than families with inheritances below $25,000. Moreover, ... high inheritance families experienced lower earnings growth than low inheritance families, which is consistent with the notion that inheritance reduces hours of work" (pp. 432-433). Theory suggests also that those who choose to remain in the labor force will reduce their hours worked or labor earnings. Holtz-Eakin, Joulfaian, and Rosen find these effects to be small.

[92] For some exceptions, see Martin H. David and Paul L. Menchik, "Changes in Cohort Wealth Over a Generation," *Demography*, 25, August 1988; Paul L. Menchik and Martin H. David, "The Effect of Income Distribution on Lifetime Savings and Bequests," *American Economic Review,* 73, September 1983; and Edward N. Wolff, "Estimate of Household Wealth Inequality in the U.S., 1962-1983," *The Review of Income and Wealth*, 33, September 1987.

[93] See Michael K. Taussig, "Les inegalites de patrimoine aux Etats-Unis," in Kessler, Masson, Strauss-Khan (eds.) *Accumulation et Repartition des Patrimoines*. Taussig estimates shares of wealth held by the top 0.5 percent of wealth holders in the United States for various years between 1922 and 1972. Wolff, in "Estimate of Household Wealth Inequality in the U.S., 1962-1983," does not attribute any movements in wealth distribution directly to tax policy, but rather to the changes in the relative values of housing and corporate stock.

Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior," in William G. Gale, James R. Hines Jr., and Joel Slemrod (eds), *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), 2001, find mixed evidence. Using aggregate time series

Income tax does not tax all sources of income. Some suggest that by serving as a "backstop" for income that escapes income taxation, transfer taxes may help promote overall fairness of the U.S. tax system. Still others counter that to the extent that much wealth was accumulated with after-(income)-tax dollars, as an across-the-board tax on wealth, transfer taxes tax more than just those monies that may have escaped the income tax. In addition, depending upon the incidence of such taxes, it is difficult to make an assessment regarding the contribution of transfer taxes to the overall fairness of the U.S. tax system.

Even if transfer taxes are believed to be borne by the owners of the assets subject to tax, an additional conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A gift tax is assessed on the transferor of taxable gifts. Assume, for example, a mother makes a gift of $1 million to her son and incurs a gift tax liability of $450,000. From one perspective, the gift tax could be said to have reduced the mother's current economic well-being by $450,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son $2 million, so that the gift tax has reduced the son's economic well-being by $1 million. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the donor and recipient generations may not be important to assessing the fairness of transfer taxes if both the donor and recipient have approximately the same income.[94]

Federal estate taxation and charitable bequests

The two unlimited exclusions under the Federal estate tax are for bequests to a surviving spouse and for bequests to a charity. Because the proposed marginal tax rate under the estate tax is 45 percent, while marginal income tax rates range from 10 to 35 percent (39.6 percent after 2010), the after-tax cost of a charitable bequest is lower than the after-tax cost of a charitable gift made during one's lifetime.[95] Economists refer to this incentive as the "price" or "substitution

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data, Kopczuk and Slemrod find a negative correlation between the share of wealth held by top wealth holders and the estate tax rates. That finding would imply that the estate tax may mitigate the concentration of wealth among top wealth holders. Wojciech Kopczuk and Emmanuel Saez, "Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns," *National Tax Journal*, 57, September 2004, pp. 445-487, report a similar result. However, when Kopczuk and Slemrod use pooled cross section analysis to make use of individual estate tax return data, they find at best a weak relationship between estate tax rates and wealth holdings.

[94] Researchers have found that the correlation of income between parents and children is less than perfect. For analysis of the correlation of income among family members across generations, see Gary R. Solon, "Intergenerational Income Mobility in the United States," *American Economic Review*, 82, June 1992, and David J. Zimmerman, "Regression Toward Mediocrity in Economic Stature," *American Economic Review*, 82, June 1992. These studies, however, examine data relating to a broad range of incomes in the United States and do not directly assess the correlation of income among family members with transferors subject to the estate tax.

[95] Economists note that when expenditures on specified items are permitted to be deducted from the tax base, before the computation of tax liability, the price of the deductible item is effectively reduced by a percentage equal to the taxpayer's marginal tax rate. Assume, for example, a decedent has a $1 million taxable estate and that the marginal, and average, estate tax rate were 40 percent. This means that the estate tax liability would be $400,000. A net of $600,000 would be available for distribution to heirs. If, however, the decedent had provided that his estate make a charitable bequest of $100,000, the taxable estate would equal $900,000 and the estate tax liability would be $360,000. By bequeathing $100,000 to charity, the estate's tax liability fell by $40,000. The net

effect." In short, the price effect says that if something is made cheaper, people will do more of it. Some analysts have suggested that the charitable estate tax deduction creates a strong incentive to make charitable bequests and that changes in Federal estate taxation could alter the amount of funds that flow to charitable purposes. The decision to make a charitable bequest arises not only from the incentive effect of a charitable bequest's deductibility, or "tax price," but also from what economists call the "wealth effect." Generally the wealthier an individual is, the more likely he or she is to make a charitable bequest and the larger the bequest will be. Because the estate tax diminishes the value of wealth to an heir, the wealth effect would suggest repeal of the estate tax could increase charitable bequests.

A number of studies have examined the effects of estate taxes on charitable bequests. Most of these studies have concluded that, after controlling for the size of the estate and other factors, deductibility of charitable bequests encourages taxpayers to provide charitable bequests.[96] Some analysts interpret these findings as implying that reductions in estate taxation, as under the budget proposal, could lead to a reduction in funds flowing into the charitable sector. This is not necessarily the case, however. Some charitable bequests may substitute for lifetime giving to charity, in part to take advantage of the greater value of the charitable deduction under the estate tax than under the income tax that results from the lower marginal income tax rates and limitations on annual lifetime giving. If this is the case, reductions in the estate tax could lead to increased charitable giving during the taxpayer's life. On the other hand, some analysts have suggested that a more sophisticated analysis is required recognizing that a taxpayer may choose among bequests to charity, bequests to heirs, lifetime gifts to charity, and lifetime gifts to heirs and recognizing that lifetime gifts reduce the future taxable estate and

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available for distribution to heirs after payment of the estate tax and payment of the charitable bequest would be $540,000. The $100,000 charitable bequest reduced the amount of funds available to be distributed to heirs by only $60,000. Economists say that the $100,000 charitable bequest "cost" $60,000, or that the "price" of the bequest was 60 cents per dollar of bequest. More generally, the "price" of charitable bequest equals (1 - t), where t is the estate's marginal tax rate.

[96] For example, see Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; David Joulfaian, "Charitable Bequests and Estate Taxes," *National Tax Journal*, 44, June 1991, pp. 169-180; and Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics*, 59, 1996, pp. 55-68. David Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," *National Tax Journal*, 53, September 2000, pp. 743-763, provides a survey of these studies and presents new evidence. Each of these studies estimates a tax price elasticity in excess of 1.6 in absolute value. This implies that for each 10-percent reduction in the tax price, where the tax price is defined as one minus the marginal tax rate, there is a greater than 16-percent increase in the dollar value of charitable bequests. Such a finding implies that charities receive a greater dollar value of bequests than the Treasury loses in forgone tax revenue. In a more recent study, Michael J. Brunetti, "The Estate Tax and Charitable Bequests: Elasticity Estimates Using Probate Records," *National Tax Journal*, 58, June 2005, pp. 165-188, finds price elasticities in excess of 1.2.

Not all studies find such responsiveness of charitable bequests to the marginal estate tax rate. Thomas Barthold and Robert Plotnick, "Estate Taxation and Other Determinants of Charitable Bequests," *National Tax Journal*, 37, June 1984, pp. 225-237, estimated that marginal tax rates had no effect on charitable bequests.

consumption. In this more complex framework, reductions in estate taxation could reduce lifetime charitable gifts.[97]

Federal transfer taxes and complexity

Critics of Federal transfer taxes document that these taxes create incentives to engage in avoidance activities. Some of these avoidance activities involve complex legal structures and can be expensive to create. Incurring these costs, while ultimately profitable from the donors' and donees' perspective, is socially wasteful because time, effort, and financial resources are spent that lead to no increase in productivity. Such costs represent an efficiency loss to the economy in addition to whatever distorting effects Federal transfer taxes may have on other economic choices such as saving and labor supply discussed above. For example, in the case of family-owned businesses, such activities may impose an ongoing cost by creating a business structure to reduce transfer tax burdens that may not be the most efficient business structure for the operation of the business. Reviewing more complex legal arrangements increases the administrative cost of the Internal Revenue Service. There is disagreement among analysts regarding the magnitude of the costs of avoidance activities.[98] It is difficult to measure the extent to which any such costs incurred are undertaken from tax avoidance motives as opposed to succession planning or other motives behind gifts and bequests.

Alternatives to the current U.S. estate tax system

Some argue that, rather than modifying and making permanent the present U.S. estate tax system, Congress should consider an alternative structure. The choice of one form of wealth transfer tax system over another necessarily will involve tradeoffs among efficiency, equity, administrability, and other factors. A determination whether one system is preferable to another could be made on the basis of each system's relative success in achieving one or a majority of these goals, without sacrificing excessively the achievement of the others. Alternatively, such a determination could be made based on which system provides the best mix of efficiency, equity, and administrability.

The United States, State governments, and foreign jurisdictions tax transfers of wealth in many different ways. Some wealth transfer tax systems, for example, impose a tax on the transferor. Such systems include the U.S. estate and gift tax system, which imposes a gift tax on

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[97] Auten and Joulfaian, "Charitable Contributions and Intergenerational Transfers," attempted to estimate this more complex framework. Their findings suggest that reductions in estate taxation would reduce charitable contributions during the taxpayer's life.

[98] Joint Economic Committee, "The Economics of the Estate Tax," December 1998, has stated "the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised." Richard Schmalbeck, "Avoiding Federal Wealth Transfer Taxes," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), 2001, disagrees writing "[a]bout half of the estate planners consulted in the preparation of this paper reported that they had rather standard packages that they would make available to individuals who would leave estates in the three to ten million range that might be provided for as little as $3000 to $5000." See William G. Gale and Joel B. Slemrod, "Life and Death Questions About the Estate and Gift Tax," *National Tax Journal*, 53, December 2000, pp. 889-912, for a review of the literature on compliance cost.

certain gratuitous lifetime transfers, an estate tax on a decedent's estate, and a generation-skipping transfer tax on certain transfers that skip generations. Another approach that involves imposition of a tax on a transferor is a "deemed-realization" approach, under which a gratuitous transfer is treated as a realization event and the gain on transferred assets, if any, generally is taxed to the transferor as capital gain.

Other wealth transfer tax systems tax the transferee of a gift or bequest. Such systems include inheritance (or "accessions") tax systems, under which a tax is imposed against the recipient of a gratuitous transfer. Some jurisdictions do not impose a separate tax, but instead treat receipts of gifts or bequests as gross income of the recipient (an "income inclusion approach").

Regardless of whether the tax is imposed against the transferor or the transferee, some commentators assert that the real economic burden of any approach to taxing transfers of wealth falls on the recipients, because the amount received effectively is reduced by the amount of tax paid by the transferor or realized by the transferee.[99] Some commentators argue that systems that impose a tax based on the circumstances of the transferee –such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a greater number of transferees and potentially to lower-income beneficiaries. Others assert that such systems promote fairness in the tax system. However, the extent to which one form of transfer tax system in practice is more effective than another in achieving these goals is not clear.

Wealth transfer tax systems other than an estate tax also may present benefits or additional challenges in administration or compliance. Inheritance taxes or income inclusion systems, for example, may reduce the need for costly tax planning in the case of certain transfers between spouses. At the same time, to the extent such systems are effective in encouraging distributions to multiple recipients in lower tax brackets, they may be susceptible to abuse such as through the use of multiple nominal recipients as conduits for a transfer intended for a single beneficiary.

Prior Action

The proposal was contained in the President's fiscal year 2010 budget proposal. The President's fiscal year 2002 through 2009 budget proposals included a proposal to make permanent after 2010 the repeal of the estate and generation skipping taxes, as scheduled to be in effect in 2010 under EGTRRA.

[99] See, e.g., Lily L. Batchelder, "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax," The Hamilton Project, The Brookings Institution, Discussion Paper 2007-07, at 5 (June 2007); "Alternatives to the Current Wealth Transfer Tax System," in American Bar Association, Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes 171 app. A (2004); Joseph M. Dodge, "Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax," *SMU Law Review* 56 (2003), 551, 556.

I. Other Incentives for Families and Children (includes extension of the adoption tax credit, employer-provided child care tax credit, and dependent care tax credit)

Present Law

Adoption credit and exclusion from income for employer-provided adoption assistance

Present law for 2010 provides: (1) a maximum adoption credit of $13,170 per eligible child (both special needs and non-special needs adoptions); and (2) a maximum exclusion of $13,170 per eligible child (both special needs and non-special needs adoptions). These dollar amounts are adjusted annually for inflation. These benefits are phased-out over a $40,000 range for taxpayers with modified adjusted gross income ("modified AGI") in excess of certain dollar levels. For 2010, the phase-out range is between $182,520 and $222,520. The phaseout threshold is adjusted for inflation annually, but the phaseout range remains a $40,000 range.

For taxable years beginning after December 31, 2011, the adoption credit and employer-provided adoption assistance exclusion are available only to special needs adoptions and the maximum credit and exclusion are reduced to $6,000, respectively. The phase-out range is reduced to lower income levels (i.e., between $75,000 and $115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation.

Employer-provided child care tax credit

Taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed $150,000 per taxable year.

Qualified child care expenses include costs paid or incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified child care facility; (2) for the operation of the taxpayer's qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable State and local laws and regulations, including any licensing laws. A facility is not treated as a qualified child care facility with respect to a taxpayer unless: (1) it has open enrollment to the employees of the taxpayer; (2) use of the facility (or eligibility to use such facility) does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code); and (3) at least 30 percent of the children enrolled in the center are dependents of the taxpayer's employees, if the facility is the principal trade or business of the taxpayer. Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code.

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the 10-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax. Other rules apply.

This tax credit expires for taxable years beginning after December 31, 2010.

Dependent care tax credit

The maximum dependent care tax credit is $1,050 (35 percent of up to $3,000 of eligible expenses) if there is one qualifying individual, and $2,100 (35 percent of up to $6,000 of eligible expenses) if there are two or more qualifying individuals. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income above ("AGI") $15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over $43,000.

The level of this credit is reduced for taxable years beginning after December 31, 2010, under the EGTRRA sunset.

Description of Proposals

Adoption credit and exclusion from income for employer-provided adoption assistance

The proposal permanently extends these two tax benefits at current levels.

Employer-provided child care tax credit

The proposal permanently extends this tax benefit.

Expansion of dependent care tax credit

The proposal permanently extends the dependent care tax credit at current levels. A separate budget proposal, described in section IV.B. of this document, expands the dependent care tax credit.

Effective date.−The proposals all apply to taxable years beginning after December 31, 2010.

Analysis

Adoption credit and exclusion from income for employer-provided adoption assistance

The adoption credit and exclusion reduce the after-tax cost of adoption for eligible taxpayers. Proponents of the benefits for adoption have argued that increasing the size of both the adoption credit and exclusion and expanding the number of taxpayers who qualify for the tax benefits have encouraged more adoptions and allowed more families to afford adoption.

Some question whether the Code is the appropriate means to subsidize adoption, for reasons including whether the benefits are most appropriately targeted and whether the IRS has the ability to monitor the claims of taxpayers. They argue that such subsidization should be via direct outlay programs, perhaps administered by the States. However, while States might reasonably administer adoption programs for domestic adoptees, it is an open question whether arranging or subsidizing foreign adoptions is an appropriate State function. Some too might argue that it is not an appropriate Federal function to subsidize foreign adoptions through Federal tax credits.

Some express concern that availability of two separate tax benefits for adoptions raises horizontal equity, complexity and compliance issues. While the credit is broadly available, the exclusion applies only to those whose employers provide adoption assistance programs. Comparable tax benefits could be provided to all if the exclusion were eliminated and the credit were allowed to be claimed on any employer-provided adoption assistance. This would have the effect of treating employer-provided assistance as ordinary compensation and of treating the payment of adoption expenses as paid by the employee from ordinary compensation. The elimination of the exclusion would also simplify the treatment of adoption expenses under the Code.

Employer-provided child care tax credit and dependent care tax credit

While certain tax benefits for children are not dependent on employment (the child credit and dependent exemption for example), the employer-provided child credit and dependent care tax credit are intended to subsidize child care needs related to employment.

Some question whether the Code should provide any child-related tax benefits, on the grounds that having children is a personal choice of private consumption. Others note that the future health of the economy is dependent on the productivity of the next generation of workers, who will also provide the resources that fund the current working generation's Social Security and Medicare benefits, and thus they argue that supporting families that choose to have children is an appropriate public function. Furthermore, they argue, a tax system premised on ability to pay must make allowances for the number of individuals in a tax filing unit.

A separate argument exists for child-care-related tax benefits that relate to child care expenses necessary for employment. The argument is that these child care expenses are an expense of earning income, and thus should essentially be deductible by analogy to general business tax principles that permit deductions for expenses (such as wages paid) necessary to earn income. Furthermore, many economists would argue that a deduction for these expenses would provide income tax treatment that is comparable to the treatment provided home production of child care–i.e, the value of home production is untaxed since the Code does not impute income to the household that provides child care services. Such households are treated as if they had income imputed to them for the services provided, but coupled with a deduction for such expenses, resulting in no increase in net income. If a worker were provided similar treatment via deductibility of child care expense, his net taxable income would rise only to the extent that his compensation exceeded that of his child care expenses.

The dependent care tax credit generally provides tax benefits less valuable than those that a full deduction for child care expense would provide. The principal reason for this is that expenses eligible for the credit are limited to an amount that is substantially less than day care costs for many taxpayers. Additionally, the credit rate for some taxpayers is less than their marginal tax rate, meaning that the deduction for the expense would provide a greater benefit than does a lower-rate credit. For a taxpayer with modest daycare expenses (if, for example, a parent only needs part-time daycare), his expenses might not be limited by the caps, and if he is a low-income taxpayer, he is likely to have a marginal income tax rate below that of the credit rate. Such taxpayer thus receives a tax benefit from the credit that is more generous than a deduction for expenses would provide at his low marginal tax rate.

Arguments for the employer-provided child care tax credit are less clear, as the benefits are not broadly available. While the credit provides benefits to employees and improves the day-care options for employees whose employers utilized the credit, a tax policy rationale for subsidizing this form of employee compensation over other forms is not immediately apparent when the dependent care tax credit is available. In the absence of the credit for employer-provided child care, an employer may still choose to provide on-site day care if it provides an advantage in recruiting and retaining valued employees. The existence of the employer subsidy and the dependent care benefit arguably provides double benefits for certain taxpayers.

Finally, while many might support the idea that families with children, specifically those with child care costs related to employment earnings, should face a lower tax burden, many among this group would prefer to see a reform of the tax system that simplifies these benefits along traditional tax policy principles, rather than extending provisions set to expire.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009 and 2010 budget proposals.

J. Reinstate the Overall Limitation on Itemized Deductions and the Personal Exemption Phase-out

Present Law

Overall limitation on itemized deductions ("Pease" limitation)

Unless an individual elects to claim the standard deduction for a taxable year, the taxpayer is allowed to deduct his or her itemized deductions. Itemized deductions generally are those deductions which are not allowed in computing adjusted gross income ("AGI"). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Prior to 2010, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was limited for upper-income taxpayers. In computing this reduction of total itemized deductions, all limitations applicable to such deductions (such as the separate floors) were first applied and, then, the otherwise allowable total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer's AGI exceeded a threshold amount which was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80 percent.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed this overall limitation on itemized deductions with the repeal phased-in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007: (2) a two-thirds reduction in 2008, and 2009; and (3) no overall limitation on itemized deductions in 2010. Thus in 2009, for example, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was reduced by three percent of the amount of the taxpayer's AGI in excess of $166,800 ($83,400 for married couples filing separate returns). Then the overall reduction in itemized deductions was phased-down to 1/3 of the full reduction amount (that is, the limitation was reduced by two-thirds).

Pursuant to the general EGTRRA sunset, the phased-in repeal of the Pease limitation sunsets and the limitation becomes fully effective again in 2011. Adjusting for inflation, the Joint Committee Staff estimates the AGI threshold would be $171,100 for 2011.

Personal exemption phase-out for certain taxpayers ("PEP")

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2010, the amount deductible for each personal exemption is $3,650. This amount is indexed annually for inflation.

Prior to 2010, the deduction for personal exemptions was reduced or eliminated for taxpayers with incomes over certain thresholds, which were indexed annually for inflation. Specifically, the total amount of exemptions that could be claimed by a taxpayer was reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeded the applicable threshold. (The phase-out rate was two percent for each $1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed was phased-out over a $122,500 range (which was not indexed for inflation), beginning at the applicable threshold.

In 2009, for example, the applicable thresholds were $166,800 for single individuals, $250,200 for married individuals filing a joint return and surviving spouses, $199,950 for heads of households, and $125,100 for married individuals filing separate returns.

EGTRRA repealed PEP with the repeal phased-in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007: (2) a two-thirds reduction in 2008, and 2009; and (3) no PEP in 2010. However, under the EGTRRA sunset, the PEP becomes fully effective again in 2011. According to Joint Committee Staff estimates the PEP thresholds for 2011 would be: (1) $171,100 for unmarried individuals; (2) 256,700 for married couples filing joint returns; and (3) $213,900 for heads of households.

Description of Proposal

Overall limitation on itemized deductions ("Pease" limitation)

The proposal would modify the overall limitation on itemized deductions. Specifically, the overall limitation on itemized deductions would apply with a new AGI threshold beginning in 2011.[100] For 2011, the AGI threshold would be determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This 2009 dollar amount is $200,000 ($250,000 for joint returns). Future years would be adjusted for inflation.

Personal exemption phase-out for certain taxpayers ("PEP")

The proposal would modify the personal exemption phase-out. Specifically, the personal exemption phase-out would apply with a new AGI threshold beginning in 2011.[101] For 2011 the AGI threshold would be determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This dollar amount is: (1) $200,000 for unmarried individuals; (2) $250,000 for joint returns; and (3) $125,000 for married couples filing separately. Future years would be adjusted for inflation.

Effective date.−The proposal applies to taxable years beginning after December 31, 2010.

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[100] The repeal of the overall limitation on itemized deductions for 2010 provided under present law would not affected by this proposal.

[101] The repeal of the personal exemption phase-out for 2010 provided under present law would not affected by this proposal.

Analysis

Overall limitation on itemized deductions ("Pease" limitation)

The general limitation on itemized deductions increases the effective marginal tax rate for affected taxpayers. This limitation reduces (subject to the 80 percent limitation) the amount of certain itemized deductions that may be claimed by an amount equal to 3 percent of each dollar of income in excess of the threshold. Thus, if a taxpayer who is above the threshold earns an additional $1.00 of income, the taxpayer's taxable income increases by $1.03 because the taxpayer's income goes up by $1.00 and the itemized deductions are reduced by 3 cents. For a taxpayer in the 36 percent tax bracket, the increase in tax liability resulting from the $1.00 increase in income will be $0.37 (the $1.03 in additional taxable income multiplied by 36 percent). Generally, the effective marginal tax rate for taxpayers subject to the limitation on itemized deductions is 3 percent higher than the statutory tax rate. That is, the taxpayer's effective marginal tax rate equals 103 percent of the statutory marginal tax rate. However, once the taxpayer's itemized deductions are reduced by 80 percent, the taxpayer's effective marginal tax rate again equals his or her statutory marginal tax rate.

Some argue that the limitation on itemized deductions diminishes a taxpayer's incentive to make charitable contributions. While there may be a psychological effect, generally there is little or no difference in the tax motivated economic incentive to give to charity for a taxpayer subject to the limitation compared to a taxpayer not subject to the limitation. This is because while the limitation operates effectively to increase the marginal tax rate on the income of affected taxpayers, the value of the tax benefit of deductibility of the charitable deduction is determined by the statutory tax rate. For taxpayers beyond the threshold, a specified dollar amount of itemized deductions are denied. The specified dollar amount is determined by the taxpayer's income, not by the amount of itemized deductions the taxpayer claims. Hence, the value of an additional dollar contributed to charity increases by exactly one dollar times the total amount of itemized deductions that the taxpayer may claim. Because the statutory rates apply to taxable income (income after claiming permitted itemized deductions), the value of the additional contribution to charity is determined by the statutory tax rate. Economists would say that the "tax price" of giving is not altered by the limitation.[102]

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[102] This can be seen mathematically as follows. Let *Y* be the taxpayer's income and *X* be the threshold above which the limitation on itemized deductions applies. Let *D* be itemized deductions and *t* the taxpayer's marginal tax rate. Then the taxpayer's total tax liability, *T*, is:

$$T = [Y - \{D -(.03)(Y - X)\}]t$$

or

$$T = Y[1 + (.03)]t - Dt -(.03)tX.$$

What this implies is that as the taxpayer's income, *Y*, increases by $1.00, his or her tax liability increases by (1.03)*t*, as noted in the text. However, if the taxpayer increases his or her itemized deductions, D, by $1.00, his or her reduction in tax liability is *t* dollars. In other words, the statutory tax rate determines the value of the deduction. This algebra assumes the taxpayer is not subject to the 80-percent limitation.

Proponents of the reinstatement of the Pease limitation (as provided by the sunset provisions of EGTRRA) argue that those who are relatively well-off should be restricted in their ability to benefit from itemized deductions, and that raising more revenue from the relatively well-off is appropriate given the magnitude and growing size of the Federal deficit.

Opponents of the reinstatement of the Pease limitation argue that the overall limitation on itemized deductions is an unnecessarily complex mechanism for imposing taxes and that the "hidden" way in which the limitation raises marginal tax rates undermines respect for the tax laws. The overall limitation on itemized deductions is reflected in a 12-line worksheet. Moreover, the first line of that worksheet requires the adding up of seven line items from Schedule A of the Form 1040, and the second line requires the adding up of five line items of Schedule A of the Form 1040. The legislative history for EGTRRA states that reducing the application of the overall limitation on itemized deductions would significantly reduce complexity for affected taxpayers.

Personal exemption phase-out for certain taxpayers ("PEP")

The personal exemption phase-out would increase effective marginal tax rates for affected taxpayers. The personal exemption phase-out would operate by reducing the amount of each personal exemption that the taxpayer could claim by two percent for each $2,500 (or portion thereof) by which the taxpayer's income exceeded the designated threshold for his or her filing status. Thus, for a taxpayer who was subject to the personal exemption phase-out, earning an additional $2,500 would reduce the amount of each personal exemption he or she could claim by two percent, or by $73 in 2011 (0.02 times the $3,650[103] personal exemption). The taxpayer's additional taxable income would be equal to the $2,500 plus the $73 in denied exemption for each personal exemption. For a taxpayer in the 36 percent statutory marginal tax rate bracket, the effective marginal tax rate on the additional $2,500 of income equals the statutory 36 percent plus an additional 1.05 percent ($73 times the statutory rate of 0.36, divided by the $2,500 in incremental income) for each personal exemption. Thus, if this taxpayer claims four personal exemptions, his or her effective marginal tax rate is 40.2 percent (the statutory 36 percent rate plus four times 1.05 percent). More generally, for 2011 a taxpayer's effective marginal tax rate equals the taxpayer's statutory marginal rate multiplied by one plus the product of 2.92 percentage points (the $73 in denied personal exemption divided by the incremental $2,500 in income) multiplied by the number of personal exemptions claimed. Thus, a taxpayer claiming four personal exemptions would have an effective marginal tax rate approximately 111.7 percent of the statutory marginal tax rate (or 40.2 percent).

Proponents of the reinstatement of the phase-out of the personal exemption (as provided by the sunset provisions of EGTRRA) argue that those who are relatively well-off should be restricted in their ability to benefit from personal exemptions, and that raising more revenue from the relatively well-off is appropriate given the magnitude and growth of the Federal deficit.

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[103] The $3,650 exemption level will increase for 2011 by the as yet undetermined inflation adjustment.

Opponents of the reinstatement argue that the high cost of raising children should properly be reflected at all levels of the income distribution, on the grounds that those who are relatively well-off but have no children should face a higher tax burden than those who are relatively well-off but with children, in the same manner that a couple earning $50,000 without children is required to pay more tax than a couple earning $50,000 with children. Opponents further argue that the personal exemption phase-out imposes excessively high effective marginal tax rates on families with children, is an unnecessarily complex mechanism for imposing income taxes, and that the "hidden" way in which the phase-out raises taxes undermines respect for tax laws.

Prior Action

Proposals to repeal the EGTRRA sunset with regard to the personal exemption phase-out and the limitation on itemized deductions were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, 2009 and 2010 budget proposals.

III. TEMPORARY RECOVERY MEASURES

A. Extend the Making Work Pay Credit for One Year

Present Law

In general

The making work pay credit is a temporary refundable income tax credit available to eligible individuals for two years (taxable years beginning in 2009 and 2010).

The credit is the lesser of: (1) 6.2 percent of an individual's earned income; or (2) $400 ($800 in the case of a joint return). For purposes of calculating an eligible individual's credit, the definition of earned income is the same as for the earned income tax credit with two modifications. First, earned income does not include net earnings from self-employment which are not taken into account in computing taxable income. Second, earned income includes combat pay excluded from gross income under section 112.

The credit is phased out at a rate of two percent of the eligible individual's modified adjusted gross income above $75,000 ($150,000 in the case of a joint return). For purposes of the phase-out, an eligible individual's modified adjusted gross income is the eligible individual's adjusted gross income increased by any amount excluded from gross income under sections 911, 931, or 933. An eligible individual is any individual other than: (1) a nonresident alien; (2) an individual with respect to whom another individual may claim a dependency deduction for a taxable year beginning in a calendar year in which the eligible individual's taxable year begins; and (3) an estate or trust.

In 2009, the otherwise allowable making work pay credit allowed was reduced by the amount of any payment received by the taxpayer pursuant to the provisions of the American Recovery and Reinvestment Act of 2009[104] providing economic recovery payments from the Veterans Administration, Railroad Retirement Board, and the Social Security Administration and a temporary refundable tax for certain government retirees.[105] Each tax return on which the credit is claimed must include the social security number of the taxpayer (in the case of a joint return, the social security number of at least one spouse).

Present law treats the failure to reduce the making work pay credit by the amount of such payments or credit, and the omission of the correct social security number, as clerical errors. This allows the IRS to assess any tax resulting from such failure or omission without the

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

[105] The credit for certain government retirees was available for 2009. The credit was $250 ($500 for a joint return where both spouses are eligible individuals). An eligible individual for these purposes was an individual: (1) who received an amount as a pension or annuity for service performed in the employ of the United States or any State or any instrumentality thereof, which was not considered employment for purposes of Social Security taxes; and (2) who did not receive an economic recovery payment under the Veterans Administration, Railroad Retirement Board, or the Social Security Administration.

requirement to send the taxpayer a notice of deficiency allowing the taxpayer the right to file a petition with the Tax Court.

Treatment of the U.S. possessions

Mirror code possessions[106]

In the case of mirror code possessions, the U.S. Treasury makes two payments (for 2009 and 2010, respectively) to each mirror code possession, each in an amount equal to the aggregate amount of the making work pay credits allowable by reason of the provision to that possession's residents against their income tax. This amount is determined by the Treasury Secretary based on information provided by the government of the respective possession. A possession is a mirror code possession if the income tax liability of residents of the possession under that possession's income tax system is determined by reference to the U.S. income tax laws as if the possession were the United States.

Non-mirror code possessions[107]

In the case of possessions that do not have a mirror code tax system, the U.S. Treasury makes two payments (for 2009 and 2010, respectively) each in an amount estimated by the Secretary as being equal to the aggregate credits that would have been allowed to residents of that possession for the taxable year if a mirror code tax system had been in effect in that possession. Accordingly, the amount of each payment to a non-mirror Code possession is an estimate of the aggregate amount of the credits that would be allowed to the possession's residents if the credit provided by the provision to U.S. residents were provided by the possession to its residents. This payment is not made to any U.S. possession unless that possession has a plan that has been approved by the Secretary under which the possession will promptly distribute the payment to its residents.

General rules

No credit against U.S. income tax is permitted for any person to whom a making work pay credit is allowed against possession income taxes (for example, under that possession's mirror income tax). Similarly, no credit against U.S. income tax is permitted for any person who is eligible for a payment under a non-mirror code possession's plan for distributing to its residents the payment described above from the U.S. Treasury.

For purposes of the payments to the possessions, the Commonwealth of Puerto Rico and the Commonwealth of the Northern Mariana Islands are considered possessions of the United States.

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[106] Possessions with mirror code tax systems are the United States Virgin Islands, Guam, and the Commonwealth of the Northern Mariana Islands.

[107] Possessions that do not have mirror code tax systems are Puerto Rico and American Samoa.

For purposes of the rule permitting the Treasury Secretary to disburse appropriated amounts for refunds due from certain credit provisions of the Code, the payments required to be made to possessions under the provision are treated in the same manner as a refund due from the making work pay credit.

Federal programs or Federally-assisted programs

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and is not taken into account as resources for the month of receipt and the following two months for purposes of determining the eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Description of Proposal

The proposal extends the making work pay credit for one year (through December 31, 2011).

Effective date.−The proposal is effective on the date of enactment.

Analysis

Proponents of the proposal argue that the tax burdens on working families eligible for the making work pay credit are too high, and that an extension is justified to reduce this burden and offset the regressivity of the Social Security payroll taxes. Proponents argue that this reduction in the overall tax liability for working Americans will encourage work, savings and investment, contributing to the long-term health of the economy.

Critics of the proposal note that, while Social Security payroll taxes are regressive, the Social Security system as a whole, when benefits are considered, is progressive. Further, they note that other refundable credits that have in the past been justified as offsetting the regressivity of the payroll taxes, notably the earned income tax credit, already offset more than the payroll tax liability for many lower income taxpayers. These critics may also prefer that any further income tax based offsets to payroll taxes be part of comprehensive reform of the Social Security system.

Critics further note that the long-term fiscal picture of the United States is bleak, and new revenues will be needed to meet the needs of an aging population. Thus, further tax cuts should not be contemplated at this time in their view. Proponents recognize the need to address long term fiscal imbalances, but argue that the proposal is a temporary one year extension, necessary at this time to help sustain the continuing economic recovery.

Critics of the proposal further note that the credit will provide little in the way of work or saving incentives, because the credit is "inframarginal" for most taxpayers─that is, while the credit reduces tax liability, it does not change the marginal tax rate at which most credit recipients pay tax on an additional dollar of labor or capital income, and thus it does not change incentives to work or save since it does not change the after-tax return to labor or saving. This is because the credit reaches its maximum value at earnings of $12,903 for married taxpayers filing jointly and only $6,452 for other taxpayers, providing no further incentive to work if one's earnings already exceed those levels, which is the case for the vast majority of recipients of the credit.

Prior Action

A proposal to permanently extend the making work pay credit was included in the President's fiscal year 2010 budget proposal.

B. Provide $250 Economic Recovery Payment and Special Tax Credit

Present Law

Making work pay credit

The making work pay credit is a temporary refundable income tax credit available to eligible individuals for two years (taxable years beginning in 2009 and 2010).

The credit is the lesser of: (1) 6.2 percent of an individual's earned income; or (2) $400 ($800 in the case of a joint return). For purposes of calculating an eligible individual's credit, the earned income definition is the same as for the earned income tax credit with two modifications. First, earned income does not include net earnings from self-employment which are not taken into account in computing taxable income. Second, earned income includes combat pay excluded from gross income under section 112.

The credit is phased out at a rate of two percent of the eligible individual's modified adjusted gross income above $75,000 ($150,000 in the case of a joint return).

In 2009, the otherwise allowable making work pay credit was reduced by the amount of any payment received by the taxpayer pursuant to the provisions of the American Recovery and Reinvestment Act of 2009 ("ARRA")[108] providing one-time economic recovery payments to certain retirees and disabled individuals and a temporary refundable tax for certain government retirees.

American Recovery and Reinvestment Act of 2009

Economic recovery payments

In general, ARRA provided a one-time economic recovery payment of $250 in 2009 to adults eligible for Social Security benefits, Railroad Retirement benefits, veteran's compensation or pension benefits or to individuals eligible for Supplemental Security Income (SSI) benefits (excluding individuals who receive SSI while in a Medicaid institution).

Economic recovery payments were made to individuals whose address of record was in one of the 50 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa, or the Northern Mariana Islands. If an individual who was eligible for an economic recovery payment had a representative payee, the payment was made to the representative payee and the entire payment was required to be used for the benefit of the individual who was entitled to the economic recovery payment.

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

Under ARRA, an individual was eligible for only one $250 economic recovery payment regardless of whether the individual was eligible for a benefit from more than one of the four Federal programs. If the individual was also eligible for the making work pay credit in 2009 that credit was reduced by the economic recovery payment.

Individuals who were otherwise eligible for an economic recovery payment did not receive a payment if their Federal program benefits had been suspended because they were in prison, a fugitive, on probation or a parole violator, had committed fraud, or were no longer lawfully present in the United States.

Economic recovery payments are not to be taken into account as income, or taken into account as resources for the month of receipt and the following nine months, for purposes of determining the eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Economic recovery payments are not includible in gross income for income tax purposes and the payments are protected from the assignment and garnishment provisions of the four federal benefit programs. The payments are subject to the Treasury Offset Program.

<u>Special credit for certain government retirees</u>

ARRA created a $250 refundable credit ($500 for a joint return where both spouses are eligible) against income taxes owed for tax year 2009 for individuals who receive a government pension or annuity from work not covered by Social Security, and who are not eligible to receive an economic recovery payment. If the individual is also eligible for the making work pay credit, that credit is reduced by the special ARRA credit. Each tax return on which the credit is claimed is required to include the social security number of the taxpayer (in the case of a joint return, the social security number of at least one spouse).

The ARRA special credit or refund is not taken into account as income, or taken into account as resources for the month of receipt and the following two months for purposes of determining the eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Description of Proposal

Economic recovery payments

Under the proposal, a one-time economic recovery payment of $250 for 2010 ($500 for a joint return where both spouses are eligible) is provided to adults who are eligible for Social Security benefits, Railroad Retirement benefits, or veteran's compensation or pension benefits; or individuals who are eligible for SSI benefits (excluding individuals who receive SSI while in a Medicaid institution). If an individual is also eligible for the making work pay credit in 2010, that credit is reduced by the amount of the 2010 economic recovery payment.

Special credit for certain government retirees

Under the proposal, a $250 refundable income tax credit ($500 for a joint return where both spouses are eligible) for 2010 is allowed for individuals who receive a government pension or annuity from work not covered by Social Security, and who are not eligible to receive an economic recovery payment. If the individual is also eligible for the making work pay credit in 2010, that credit is reduced by this credit.

Effective date.−The proposal is effective on the date of enactment.

Analysis

The Administration believes that providing these benefits to retirees is necessary to help stimulate consumption in order to assure that the present economic recovery does not falter. The Administration further believes that assistance provided under these two proposals helps ensure equal treatment between retirees under these proposals and non-retirees receiving the making work pay credit.

Some might argue against these two proposals on the grounds that the Federal government's fiscal position is sufficiently perilous that adding to the deficit at this time may not provide the hoped-for stimulus if investors retrench on fears concerning the level of U.S. debt. Others may additionally object that these payments are not well targeted. Many retirees are in a better position economically than young families, and the payment and credit are not restricted based on income, in contrast to the making work pay credit.

C. Extend COBRA Health Insurance Premium Assistance

Present Law

The Consolidated Omnibus Reconciliation Act of 1985 ("COBRA")[109] generally requires that a group health plan offer continuation coverage to qualified beneficiaries in the case of a COBRA qualifying event (such as a loss of employment). There are certain exceptions to the general requirement to offer continuation coverage, including exceptions for small employers, government and church employers, and employers that cease to provide any group health plan to any employee.[110] A plan may require payment of a premium for any period of continuation coverage. The amount of such premium, however, generally may not exceed 102 percent of the applicable premium for such period and the premium must be payable, at the election of the payor, in monthly installments.

Section 3001 of the American Recovery and Reinvestment Act of 2009 ("ARRA"),[111] as amended by the Department of Defense Appropriations Act for Fiscal Year 2010 ("DOD Act"),[112] the Temporary Extension Act of 2010 ("TEA"),[113] and the Continuation Extension Act of 2010 ("CEA"),[114] provides that, for a period not exceeding 15 months,[115] an assistance eligible individual is treated as having paid any premium required for COBRA continuation coverage if the individual pays 35 percent of such premium. Thus, if the assistance eligible individual pays 35 percent of the premium, the group health plan must treat the individual as having paid the full premium required for COBRA continuation coverage, and the individual is entitled to a subsidy for 65 percent of the premium (the "COBRA continuation coverage subsidy"). An assistance eligible individual generally is any qualified beneficiary who elects COBRA continuation coverage and the qualifying event with respect to the covered employee for that qualified beneficiary is a loss of group health plan coverage on account of an involuntary termination of the covered employee's employment (for other than gross misconduct).[116] In addition, the

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[109] Pub. L. No. 99-272.

[110] Sec. 4980B(d) and 4980B(f)(2)(B)(ii).

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

[112] Pub. L. No. 111-118.

[113] Pub. L. No. 111-144.

[114] Pub L. No. 111-157.

[115] Under ARRA, the assistance period was limited to 9 months. The period was subsequently extended to 15 months by the DOD Act.

[116] TEA expanded eligibility for the COBRA subsidy to include individuals who experience a loss of coverage on account of a reduction in hours of employment followed by the involuntary termination of employment of the covered employee (for other than gross misconduct). For an individual first entitled to COBRA because of a reduction in hours, and then subsequently involuntarily terminated from employment, the termination is considered a qualifying event for purposes of the COBRA subsidy, as long as the termination occurs during the period beginning on the date following TEA's date of enactment and ending on May 31, 2010.

qualifying event must occur during the period beginning on September 1, 2008, and ending on May 31, 2010.[117]

The COBRA continuation coverage subsidy also applies to temporary continuation coverage elected under the Federal Employees Health Benefits Program and to continuation health coverage under State programs that provide coverage comparable to COBRA continuation coverage. The COBRA continuation coverage subsidy is generally delivered by requiring employers to pay the subsidized portion of the COBRA continuation coverage premium for assistance eligible individuals. The employer then treats the payment of the subsidized portion as a payment of Federal employment taxes and offsets its Federal employment tax liability by the amount of the subsidy. To the extent that the aggregate amount of the subsidy for all assistance eligible individuals for which the employer is entitled to a credit for a quarter exceeds the employer's Federal employment tax liability for the quarter, the employer can request a tax refund or can claim the credit against future Federal employment tax liability.

ARRA, as amended, also contains heightened notice requirements. The notice of COBRA continuation coverage that a plan administrator must provide to qualified beneficiaries with respect to a qualifying event must contain information about the qualified beneficiary's right to the COBRA continuation coverage subsidy. ARRA also provides for an expedited 10-day review process by the Department of Labor ("DOL"), under which an individual may request review of a denial of treatment as an assistance eligible individual by a group health plan.

There is an income limit on the entitlement to the COBRA continuation coverage subsidy. Taxpayers with modified adjusted gross income exceeding $145,000 (or $290,000 for joint filers), must repay any subsidy received by them, their spouse, or their dependant, during the taxable year. For taxpayers with modified adjusted gross incomes between $125,000 and $145,000 (or $250,000 and $290,000 for joint filers), the amount of the subsidy that must be repaid is reduced proportionately. The subsidy is also conditioned on the individual not being eligible for certain other health coverage. To the extent that an eligible individual receives a subsidy during a taxable year to which the individual was not entitled, the subsidy overpayment is repaid on the individual's Federal income tax return as additional tax. The COBRA continuation coverage subsidy may only be claimed through the employer and cannot be claimed at the end of the year on an individual tax return.

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[117] Under ARRA the qualifying event must have occurred on or before December 31, 2009. The DOD Act extended the period through February 28, 2010, TEA extended the period through March 31, 2010, and CEA extended the period through May 31, 2010. The DOD Act, TEA, and CEA each contained transition periods with the result that there are no gaps in the subsidy eligibility period and individuals who were involuntarily terminated during the time in between passage of the extensions are eligible for the subsidy. For example, under TEA the subsidy eligibility period ended on March 31, 2010, and CEA was not signed into law until April 15, 2010. CEA contains a transition period allowing individuals who lost their jobs on or after April 1, 2010, but before April 16, 2010, to receive the subsidy. Such individuals also have an extended period of time in which to elect COBRA coverage (generally, 60 days after they are provided with notification of the existence of the subsidy).

Description of Proposal

The proposal extends the eligibility period for the COBRA continuation coverage subsidy by allowing individuals who qualify for COBRA coverage as the result of an involuntary termination of employment prior to January 1, 2011, to qualify for the subsidy.

The proposal calls for a subsidy period of 12 months.

Effective date.–The proposal is effective on date of enactment.

Analysis

The COBRA continuation coverage subsidy is an attempt to help ease the financial impact on low- and moderate-income individuals who are unemployed as a result of the recession that began in late 2008. The proposal recognizes that, although the economy has begun to recover, unemployment rates remain elevated in certain sectors of the American workforce as a result of the economic downturn.

Despite initial hesitation from employers during and after passage of ARRA, early reports regarding the COBRA continuation subsidy have been generally positive.[118] Studies indicate both that enrollment in COBRA has increased substantially as a result of the subsidies, and that there has been less adverse selection among the individuals that choose to enroll in COBRA continuation coverage.[119] Less adverse selection may have the result of lowering employers' average cost per COBRA beneficiary, since healthier individuals usually incur less medical costs and help to subsidize less healthy enrollees. Traditionally, enrollment in COBRA has been subject to high rates of adverse selection since, generally, only less healthy individuals have been willing to pay the dramatically higher costs of COBRA continuation coverage (on average, for the period between 1999 and 2009, employees paid 17 percent of the premium of employer sponsored health care for self-only coverage, while COBRA premiums were 102 percent).[120]

Some argue that the subsidy's complex eligibility requirements and detailed enrollment process create excessive compliance, paperwork, and recordkeeping responsibilities for employers and individuals, resulting in increased costs for employers and in limited enrollment

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[118] Department of Treasury, "Interim Report to The Congress on COBRA Premium Assistance," June 2010, available at http://www.treas.gov/offices/tax-policy/library/COBRAInterimReport.pdf. Last accessed on June 28, 2010. In its interim report, at 3, Treasury reports that "COBRA premium assistance has been provided to as many as 2 million households in 2009."

[119] See, e.g., R. R. Bovbjerg, S. Dorn, and J. Macri, et. al., "COBRA Subsidies for Laid-Off Workers: An Initial Report Card," The Commonwealth Fund, December 2009, available at http://www.commonwealthfund.org/Content/Publications/Issue-Briefs/2009/Dec/The-New-COBRA-Subsidy-for-Laid-Off-Workers.aspx. Last accessed April 23, 2010.

[120] Kaiser Family Foundation and Health Research and Educational Trust, "Employer Health Benefits: 2009 Annual Survey," at Exhibit 6.1, p. 68, Sept. 15, 2009, available at http://ehbs.kff.org. Last accessed on April 23, 2010.

by individuals.[121] In particular, some view the requirement that employers track which employees were involuntarily terminated as overly burdensome. TEA addresses that particular concern by, in most circumstances, deeming an employer's attestation of involuntary termination to be accurate. Critics have also noted that DOL often requires additional information from employers in connection with an individual's appeal of his or her denial of eligibility for the COBRA continuation coverage subsidy and employers have too limited a time in which to gather the information and respond to DOL.

Additional complexity has been necessitated by the retroactivity of the DOD Act, TEA and CEA. Such retroactivity is arguably necessary, however, so as not to unfairly disadvantage individuals who lost their jobs during the brief time periods between expiration of one of eligibility period and enactment of extending legislation. There is little doubt, however, that retroactivity creates increased administrative burdens and costs for employers and confusion about eligibility among individuals. These burdens would, arguably, be increased because the proposal calls for a subsidy period of 12 months, rather than the 15 months currently available under present law (after passage of the DOD Act, TEA, and CEA). Reverting to a 12 month period only for individuals eligible for the subsidy after May 31, 2010, may present certain administrative complexities that, some might argue, would make it less desirable than keeping the subsidy period at 15 months.

Others point out that the subsidies were rapidly implemented with few problems and at minimal cost. They argue that individuals appear to be well informed about the availability of the COBRA continuation coverage subsidy, evidenced in part by the 170,000 ARRA-related inquiries DOL has responded to as of December 21, 2009.[122] In addition, as of the end of 2009, there were over 52,000 subscribers and over 2 million visitors to the DOL COBRA web page.[123]

Some argue that the government has unnecessarily assumed a cost that was formerly born by employers at less cost to taxpayers. They point out that prior to the availability of the COBRA continuation coverage subsidy many employers offered severance packages that included health insurance premium contributions. Once the COBRA continuation coverage subsidy became available, however, employers stopped offering such generous severance packages. There is insufficient data, however, on the prevalence, or dollar value, of severance packages prior to ARRA's enactment to draw any conclusions on the effect of the subsidy on employers' practices. In addition, although employers may no longer offer health insurance

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[121] Ceridian Corporation, "Ceridian Analyzes COBRA Enrollments in Light of a Premium Subsidy in ARRA," available at http://www.ceridian.com/employee_benefits_article/1,6266,15766-72874,00.html. Last accessed on April 23, 2010.

[122] "FY 2011 Department of Labor Budget in Brief," available at http://www.dol.gov/dol/budget/2011/PDF/bib.pdf. Last accessed on April 28, 2010.

[123] *Ibid*.

premium contributions to terminated employees they may choose to make severance payments in cash, resulting in overall more generous severance benefits to unemployed individuals.[124]

There are those who argue that the COBRA continuation coverage subsidy does not help those in the most need of financial assistance. Despite the increase in the take-up rate of COBRA continuation coverage due to the subsidy, only a minority of those eligible for COBRA continuation coverage actually enroll. Even with the availability of the subsidy, many eligible individuals, particularly those at the lowest end of the economic spectrum, are unable to afford 35 percent of their COBRA premium. There is evidence that the benefit of the subsidy is accruing primarily to middle-class families.[125] Additionally, the subsidy does not help individuals who are not eligible for COBRA continuation coverage because their employer is exempt from COBRA (for example, because the employer ceased operations and stopped providing group health coverage to any employee)[126] or because the individual him or herself was not eligible for, or could not afford, employer provided health coverage while employed.[127] Individuals at the lowest income levels may be the least likely to be eligible for COBRA, since they are less likely than other employees to have been eligible for health benefits through their employer while employed (or to have been able to afford the premiums even if eligible for coverage). Those making these arguments might favor better targeted government expenditures.

Prior Action

No prior action.

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[124] There are numerous reasons that employers choose to offer severance packages to terminated individuals, including to indemnify themselves against legal claims by their former employees.

[125] U.S. Treasury Department, Office of Economic Policy, "COBRA Insurance Coverage since the Recovery Act: Results from New Survey Data," available at http://www.ustreas.gov/offices/economic-policy/cobra%20final%20report.pdf. Last accessed June 28, 2010.

[126] See, for example, Pear, R., "When a Job Disappears, So Does the Health Care," New York Times, December 6, 2008.

[127] Individuals are generally only eligible for COBRA, and for the COBRA subsidy, if they were actually covered under the employer's health plan on the day before the COBRA qualifying event.

D. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualifying Advanced Energy Manufacturing Project

Present Law

Present law provides a 30-percent credit for investment in qualified property used in a qualifying advanced energy manufacturing project. A qualifying advanced energy project is a project that re-equips, expands, or establishes a manufacturing facility for the production of: (1) property designed to be used to produce energy from the sun, wind, or geothermal deposits (within the meaning of section 613(e)(2)), or other renewable resources; (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (3) electric grids to support the transmission of intermittent sources of renewable energy, including storage of such energy; (4) property designed to capture and sequester carbon dioxide; (5) property designed to refine or blend renewable fuels (but not fossil fuels) or to produce energy conservation technologies (including energy-conserving lighting technologies and smart grid technologies); (6) new qualified plug-in electric drive motor vehicles, qualified plug-in electric vehicles, or components which are designed specifically for use with such vehicles, including electric motors, generators, and power control units; or (7) other advanced energy property designed to reduce greenhouse gas emissions as may be determined by the Secretary. A qualifying advanced energy project does not include any part of a project for the production of any property for use in the refining or blending of any transportation fuel other than renewable fuels.

Qualified property must be depreciable (or amortizable) property used in a qualifying advanced energy project. Only tangible personal property and other tangible property (not including a building or its structural components) are credit-eligible. The basis of qualified property must be reduced by the amount of credit received. No credit is allowed for any qualified investment that is allowed a credit under sections 48, 48A, or 48B.

Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. The Secretary of Treasury has established a certification program for this purpose,[128] and may allocate up to $2.3 billion in credits.

Certifications are issued using a competitive bidding process. Current Treasury guidance requires taxpayers to apply for certification with respect to their entire qualified investment in a project.[129]

In selecting projects, the Secretary may consider only those projects with a reasonable expectation of commercial viability. In addition, the Secretary must consider other selection criteria, including which projects: (1) will provide the greatest domestic job creation; (2) will provide the greatest net impact in avoiding or reducing air pollutants or anthropogenic emissions

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[128] Treasury issued guidance on its certification program on August 13, 2009. See Notice 2009-72, 2009-37 I.R.B. 325 (August 13, 2009).

[129] Notice 2009-72, 2009-37 I.R.B. 325 (August 13, 2009).

of greenhouse gases; (3) have the greatest potential for technological innovation and commercial deployment; (4) have the lowest levelized cost of generated or stored energy, or of measured reduction in energy consumption or greenhouse gas emission; and (5) have the shortest project time from certification to completion.

Each project application must be submitted during the two-year period beginning on the date the certification program was established. An applicant for certification has one year from the date the Secretary accepts the application to provide the Secretary with evidence that the requirements for certification have been met. Upon certification, the applicant has three years from the date of issuance of the certification to place the project in service. Not later than four years after February 17, 2009 (the date of enactment of the American Recovery and Reinvestment Act of 2009), the Secretary is required to review the credit allocations and redistribute any credits that were not used either because of a revoked certification or because of an insufficient quantity of credit applications.

Description of Proposal

The proposal authorizes an additional $5 billion of credits for investments in eligible property used in a qualifying advanced energy project. The proposal also modifies the guidance that requires taxpayer to apply for the credit with respect to their entire qualified investment to permit credit applications with respect to only part of such investment. This second element of the proposal will be accomplished through administrative guidance and does not require legislative action. If a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government will be taken into account in determining whether to allocate credits to the project.

Effective date.−The proposal is effective on the date of enactment.

Analysis

The proposal expands the amount of investment tax credits that may be allocated for investment in manufacturing facilities that produce specified products, many of which are also subsidized on the consumption side of the market via tax credits for their purchase. The manufacturing projects that may qualify generally have in common the feature that they produce goods whose use would displace the consumption of fossil fuels.

Economists are generally skeptical of government interventions in markets that alter prices from those that would otherwise prevail in a free market, but most would agree that a valid economic rationale for government intervention in certain markets (including many aspects of energy markets) can exist when there are "externalities" in the consumption or production of certain goods that lead to "market failures," wherein either too little or too much of certain economic activity occurs relative to what is the socially optimal level of activity.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, there are various ways the government could intervene in markets to limit pollution to more economically efficient levels. One approach is to control pollution directly through regulation of polluters, such as by requiring coal burning electric utilities to install scrubbers to limit their emissions of various pollutants. Other more market oriented approaches to achieving socially optimal levels of pollution control are also possible, such as by setting a tax on the polluting activity that is equal to the social cost of the pollution.

In the case of a positive externality, the appropriate economic policy would be to impose a negative tax (i.e., a subsidy) on the consumption or production that produces the positive externality, such that the socially optimal level of consumption or production results. An example where such a positive externality is thought to exist is in basic scientific research, as the social payoffs to such research are not fully captured by private parties that undertake, and incur the cost of, such research. As a result, a socially sub-optimal level of such research is undertaken. The provision of a subsidy for such research can correct this market inefficiency and lead to socially optimal levels of research.

It could be argued that the manufacturing credit is designed to correct inefficiently low investment in these manufacturing facilities that stems from the facilities producing positive externalities that are not captured in private investment decision making. There are problems with this argument however. There is no clear evidence that positive externalities exist from the domestic production of (a separate notion from the domestic use of) these favored items relative to production of other goods not so favored. In the absence of such externalities, government intervention that distorts investment via subsidies will lead to an inefficient and less productive allocation of resources in the society as a whole.

To the extent that positive externalities exist from the domestic use of the favored production items, the existing subsidy mechanism for the purchase of these goods should be sufficient to address any positive externality related to the use of these goods. Even in this case, economists do not generally argue that consuming wind energy, or driving an electric car, produces positive externalities and thus merits subsidy. Rather, it is thought that subsidizing these activities will divert consumption from other, less desirable consumption of fossil fuels that produce pollution and other negative externalities. However, economists generally agree that the most efficient means of addressing pollution would be a direct tax on the creation of the pollution, rather than an indirect approach that provides targeted tax credits for certain technologies.[130]

The allocation of a fixed amount of tax credits for a given activity can be criticized as leading to unfair tax results. In general, Federal tax credits are available to all taxpayers who meet the statutory eligibility requirements, and are not limited in the aggregate. A tax system that provides only a fixed amount of credits in the aggregate can lead to a situation where two taxpayers of similar means face different tax liabilities, if one has been granted an allocation of credits and the other not. While other Federal disbursements are similarly limited, many have noted that these allocated tax credits are in essence grant programs, and have questioned whether

[130] For a discussion of these issues, see written statement of Gilbert Metcalf Testimony before the Committee on Finance, U.S. Senate, April 23, 2009 at hearing on Neutrality in Energy Tax: Issues and Options. Available at http://finance.senate.gov/imo/media/doc/042309gmtest.pdf.

such programs should be run through the tax code, rather than funded directly by grants made under the auspices of other Federal departments.

When there is a limited amount of credit to allocate, providing a fixed percentage credit for the entirety of a qualifying project is not the most cost effective way for the Federal government to utilize the tax code to stimulate desirable manufacturing projects. As the Treasury Department notes in its explanation of the Administration's revenue proposal, the original $2.3 billion credit allocation funded less than one-third of technically acceptable applications. The fact that the program was oversubscribed at the 30 percent credit suggests that the credit was too generous, and that the credit rate could have been lowered while funding more projects on the same budget. Ideally, to efficiently utilize a fixed amount of credit, the government would operate some form of auction whereby applicants bid on the credit rate they would need in order to go forward with a project, and the lowest bidders would obtain the credit until the $2.3 billion were allocated. This is analogous to how the Treasury Department auctions its securities--it sets a borrowing target and elicits bids in order to obtain the lowest borrowing rate that the market will accept. The allocated credit approach is analogous to a hypothetical, and inefficient, security auction in which the Treasury Department announces it plans to borrow a fixed amount of money at a high interest rate, finds its offer oversubscribed, and then chooses to borrow from the lucky few. This would be an expensive way for the government to borrow.

The Administration proposal notes that guidance for applying for the credit will be revised to no longer require that an applicant apply for the credit with respect to their entire qualified investment, and states that "if a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government will be taken into account in determining whether to allocate credits to the project." This approach will yield efficiencies similar to the auction concept outlined above, as applicants will now in general have the incentive only to bid for as much credit as they need to make their project economically viable, less they bid for too high an allocation and lose out to a competitor, thus getting no allocation.

E. Extend Temporary Bonus Depreciation for Certain Property

Present Law

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (tangible property other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.[131] In general, the recovery periods for real property are 39 years for non-residential real property and 27.5 years for residential rental property. The depreciation method for real property is the straight-line method.

Under MACRS, the entire basis of depreciable property is recovered by the taxpayer over the applicable recovery period; there is no need to estimate salvage value. Further, under MACRS, the applicable recovery period need not (and typically does not) correspond to the actual economic life of the asset subject to depreciation. However, MACRS generally provides for longer recovery periods for longer lived assets.

Additional first-year depreciation deduction ("bonus depreciation")

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008 and 2009 (2009 and 2010 for certain longer-lived and transportation property).[132] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The

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[131] For certain property, including tangible property used predominantly outside of the United States, tax-exempt use property, tax-exempt bond-financed property, and certain other property, the MACRS "alternative depreciation system" of section 168(g) applies, generally increasing recovery periods and requiring straight-line depreciation.

[132] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2009, a taxpayer purchased new depreciable property and places it in service.[133] The property's cost is $1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is $500. The remaining $500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or $100, is also allowed as a depreciation deduction in 2009. The total depreciation deduction with respect to the property for 2009 is $600. The remaining $400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[134] Second, the original use[135] of the property must commence with the taxpayer after December 31, 2007.[136] Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2010. An extension of the placed in service date of one year (i.e., to January 1, 2011) is provided for certain property with a recovery period of ten years or longer and certain transportation

[133] Assume that the cost of the property is not eligible for expensing under section 179.

[134] The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

[135] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

[136] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

property.[137] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after December 31, 2007, and before January 1, 2010, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2010.[138] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2010. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2010 ("progress expenditures") is eligible for the additional first-year depreciation.[139]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The $8,000 increase is not indexed for inflation.

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[137] Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding $1 million.

[138] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

[139] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

Election to claim research or minimum tax credits in lieu of bonus depreciation[140]

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect, for its first taxable year ending after December 31, 2008 and each subsequent taxable year, to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for "extension property."[141] "Extension property" is property that is eligible qualified property solely by reason of the extension of the additional first-year depreciation deduction pursuant to the amendments made by section 1201(a) of the American Recovery and Reinvestment Tax Act of 2009.[142] Eligible qualified property generally is property placed in service during 2008 or 2009 (2009 or 2010 in the case of certain longer-lived and transportation property) that is otherwise eligible for the additional first-year depreciation deduction.

A corporation making the election forgoes the depreciation deductions allowable under section 168(k) and instead increases the limitation under section 38(c) on the use of research credits or section 53(c) on the use of minimum tax credits.[143] The increases in the allowable credits are treated as refundable for purposes of this provision. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

The research credit or minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation[144] for certain eligible

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[140] Sec. 168(k) was originally enacted as part of the Housing Assistance Tax Act, Pub. L. No. 110-289, and provided that a corporation otherwise eligible for additional depreciation under section 168(k) may elect, for its first taxable year ending after March 15, 2008 and each subsequent taxable year, to claim certain research or minimum tax credits in lieu of claiming the additional depreciation under section 168(k).

[141] Sec. 168(k)(4). In the case of an electing corporation that is a partner in a partnership, the corporate partner's distributive share of partnership items is determined as if section 168(k) does not apply to any eligible qualified property and the straight line method is used to calculate depreciation of such property. A taxpayer may make the election with respect to extension property without regard to whether the taxpayer made an election under section 168(k)(4) with respect to eligible qualified property for its first taxable year ending after March 31, 2008. In the case of a taxpayer electing to increase the research or minimum tax credit for eligible qualified property and extension property, a separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to each group of property. See section 168(k)(4)(H).

[142] Pub. L. No. 111-5. The American Recovery and Reinvestment Tax Act of 2009 extended the additional first-year depreciation deduction to apply to qualified property acquired and placed in service after December 31, 2008 and before January 1, 2010 (January 1, 2011 for certain longer-lived and transportation property). See discussion above.

[143] Special rules apply to an applicable partnership.

[144] For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to section 168(k)(4)), and shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property.

qualified property that could be claimed absent the election. The bonus depreciation amount is limited to the lesser of: (1) $30 million, or (2) six percent of the sum of research credit carryforwards from taxable years beginning before January 1, 2006 and minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1, 2006. All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

Description of Proposal

The proposal extends the additional first-year depreciation deduction for one year to apply to qualified property acquired and placed in service during 2010 (or placed in service during 2011 for certain long-lived and transportation property). The proposal also extends for one year the election to claim additional research or minimum tax credits in lieu of claiming the additional first-year depreciation. Under the proposal, a corporation would be allowed to choose whether or not to make an election with respect to eligible qualified property placed in service in 2010, regardless of prior-year elections.

Effective date.–The proposal is effective for qualified property placed in service after December 31, 2009.

Analysis

The proposal lowers the after-tax cost of capital expenditures made by businesses by permitting the immediate depreciation of 50 percent of the amount of the capital expenditure rather than depreciating the full cost of the expenditure over the recovery period. With a lower cost of capital, it is argued that eligible businesses will invest in more equipment and employ more workers, thus serving to stimulate economic growth among businesses taxable in the United States.

Reducing the cost of capital investments is the appropriate treatment if the policy objective is taxation of consumption, because expensing 50 percent of the cost of the capital expenditure effectively reduces the tax on the returns to investment, subject to certain assumptions.[145] If the policy objective is taxation of income, then depreciation deductions should coincide with the economic depreciation of the asset to measure economic income accurately. A depreciation system more generous than economic depreciation, but less generous

[145] For example, consider an investment of $100 that yields a $10 return in the following year, i.e., a 10-percent pre-tax return. If the tax rate is 50 percent, expensing of the $100 investment yields a $50 reduction in tax liability, meaning the after-tax cost to the taxpayer for the $100 investment is $50. The $10 return in the following year results in a $5 tax, and thus a $5 after-tax return. Thus, the after-tax return on the investment is 10 percent (5 divided by 50), the same as the pre-tax return. To fully effect consumption tax treatment, other modifications would need to be made, such as not imposing capital gains taxes with respect to sales of business equity interests and fully integrating the corporate and individual tax systems. Additionally, no business interest expense deductions could be permitted or negative effective tax rates would result. Finally, even with the changes above, any property taxes imposed at the State or local level would cause there to remain a positive effective tax rate on the return to investment.

than full expensing, results in an effective tax rate on the income from capital that is less than the statutory tax rate.

Some economic studies suggest that bonus depreciation has limited effect on investment spending.[146] One economist has estimated that for every one dollar reduction in Federal tax revenue associated with bonus depreciation there is a 27 cent change in real gross domestic product,[147] leading some commentators to assert that bonus depreciation is "a poor candidate for inclusion in an economic stimulus package designed to achieve the best bang-for-the-buck."[148]

Possible explanations for the modest stimulative effect of bonus depreciation include that the size of the incentive was relatively small given the present accelerated depreciation provisions, companies typically plan their capital spending budgets in advance and could not adapt to take advantage of the bonus deprecation, and the costs of making any such adjustments was not worth the benefit.[149] One study noted that bonus depreciation was not claimed with respect to approximately 40 percent of eligible investments.[150] The author suggested that the low takeup rate could be the result of companies with significant losses and loss carryovers, as well as the fact that many states did not allow bonus depreciation, making bonus depreciation less beneficial.

One study found that bonus depreciation significantly affected the composition of investments made by companies, with companies investing in equipment with long tax lives.[151]

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[146] Darryl Cohen and Jason Cummins, "A Retrospective Evaluation of the Effects of Temporary Partial Expensing, Finance and Economics Discussion Series 2006-19," Federal Reserve Board, Washington, DC April 2006; Matthew Knittel, "Corporate Response to Bonus Depreciation: Bonus Depreciation for Tax Years 2002-2004," U.S. Dept. of Treasury, Office of Tax Analysis Working Paper 98, May 2007; David S. Hulse and Jane R. Livingstone, Incentive Effects of Bonus Depreciation, January 2010, available at http://www.ifigr.org/workshop/spring10/Hulse.pdf.

[147] Written testimony of Mark Zandi, Chief Economist and Co-founder of Moody's Economy.com, before the House Committee on Small Business Hearing on "Economic Stimulus for Small Business: A Look Back and Assessing Need for Additional Relief," July 24, 2008.

[148] Chye-Ching Huang and Chad Stone, "Bonus Depreciation Tax Cut Unlikely to Provide Effective Economic Stimulus," Center on Budget and Policy Priorities, September 10, 2008.

[149] Cohen and Cummins, "A Retrospective Evaluation of the Effects of Temporary Partial Expensing," Finance and Economics Discussion Series 2006-19, Federal Reserve Board, Washington, DC April 2006.

[150] Matthew Knittel, "Corporate Response to Bonus Depreciation: Bonus Depreciation for Tax Years 2002-2004," U.S. Dept. of Treasury, Office of Tax Analysis Working Paper 98, May 2007.

[151] Christopher L. House and Matthew D. Shapiro, "Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation," *American Economic Review*, American Economic Association, Vol. 98(3), pages 737-68 (June 2008).

While another study concluded that bonus depreciation stimulates investment by firms with more domestic investments and that pay more taxes.[152]

Another commentator contends that bonus depreciation provisions in stimulus legislation contribute to a jobless recovery.[153] The commentator notes that incentives like bonus depreciation encourage firms to shift funds from labor to capital to take advantage of provisions like bonus depreciation that favor capital investment.[154] However, shifting from labor to capital should make labor more productive leading to higher wages.

Prior Action

None.

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[152] Estelle P. Dauchy and Claudia Martinez, "Corporate Tax Minimization and the Effectiveness of Investment Incentives," *State Tax Notes*, Vol. 47, No. 13 (March 31, 2008).

[153] Theodore P. Seto, "The Problem with Bonus Depreciation," 126 *Tax Notes* 782 (Feb. 8, 2010).

[154] *Ibid.*

F. Extend Option for Cash Assistance to States in Lieu of Low-Income Housing Tax Credit 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.[155] The amount of the credit for any taxable year in the credit period is the applicable percentage (70 percent for a new non-federally subsidized building; otherwise 30 percent) of the qualified basis of each qualified low-income building. 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 who 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.[156] These amounts are indexed for inflation.

Certain buildings that also receive financing from 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 under section 146.

Federal grants

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

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[155] Sec. 42.

[156] Rev. Proc. 2009-50 IRB 2009-45.

Grants in lieu of tax credits for 2009

Low-income housing grant election amount

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

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 and the sum of: (1) the State's 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 electing to receive a grant must 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 been allocated a low-income housing credit. However, in the case of qualified low-income buildings that have not received a 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 from potential investors 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 is required to 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.[157] Failure to satisfy the low-income housing credit rules results in recapture of the subaward enforced by means of liens or other methods that the Secretary (or his delegate) deems appropriate. Any such recapture will be payable to the Secretary for deposit in the general fund of the Treasury.

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

[157] 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.

Grants received under this election

A grant received under a State's 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.

Appropriations

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

Description of Proposal

The proposal extends for one year (2010) the ability of States to elect to substitute grants for nonrefundable tax credits.

For 2010, the maximum low-income housing refundable credit election amount for a State may not exceed 85 percent of the product of ten and the sum of: (1) the State's unused housing credit ceiling for 2009; (2) any returns to the State during 2010 of credit allocations (other than credit allocations denied, directly or indirectly under section 1400N(c) of the Code) previously made by the State; (3) 40 percent of the State's 2010 credit allocation; and (4) 40 percent of the State's share of the national pool allocated in 2010, if any.

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

The payments made under the proposal do not reduce the tax basis of a qualified low-income building.

A Federal agency other than the Internal Revenue Service (the "IRS") will continue to administer elections by State housing agencies. An electing State's housing credit agency will continue to 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. Any noncompliance will be reported to the IRS. Failure to satisfy the low-income housing credit rules will result in recapture of the subaward enforced by means of liens or other methods that the Secretary (or his delegate) deems appropriate. Any State lien or regulatory agreement will be assigned to the IRS for collection by Federal authorities. Any such recapture will be payable to the Secretary for deposit in the general fund of the Treasury.

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

Effective date.−The provision is effective on the date of enactment.

Analysis

Proponents argue that the need for additional low-income housing stock is ongoing in this country. They contend that the temporary economic downturn and attendant reductions in tax liability for many taxpayers have resulted in a reduced appetite for tax credits by many potential low-income housing tax credit investors. In addition, Freddie Mac and Fannie Mae, the two largest investors in low-income housing credit projects, suspended new investment in such projects. The possibility that Freddie Mac and Fannie Mae might transfer some or all of their holdings in low-income housing credit projects may also create uncertainty in the market and discourage other new investment. Proponents argue that this program allows the States the flexibility they need to encourage investment in the short-term while retaining the tax credit structure for future years.

Opponents may question whether the delay in enacting this proposal (e.g., in the last six months of calendar year 2010) reduces its efficacy.

Opponents voice concern that the Federal Government, rather than the individual States, has the most incentive to ensure compliance with any Federal tax subsidy. Proponents may respond that the proposal returns more of this compliance responsibility to the IRS.

Another argument against the proposal is that the conversion of tax benefits to cash usurps the traditional role of direct Federal appropriations and the continuing Congressional oversight attendant with such appropriated monies. Proponents may respond that such concern is less warranted in the case of a short-term program.

IV. TAX CUTS FOR FAMILIES AND INDIVIDUALS

A. Increase in the Earned Income Tax Credit

Present Law

Overview

Low- and moderate-income workers may be eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income[158] up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,100 (for 2010). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive a portion of the credit in their paychecks, rather than waiting to claim a refund on their tax returns filed in the following year.[159]

Filing status

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for

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[158] For purposes of the EITC, earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

[159] Section 219 of H.R. 1586, signed into law by the President on August 10, 2010, eliminates the advance refundability of the EITC effective for taxable years beginning after December 31, 2010.

the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year,[160] and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.[161]

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $5,980, resulting in a maximum credit of $457 for 2010. The maximum is available for those with incomes between $5,980 and $7,480 ($12,490 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above $7,480 ($12,480 if married filing jointly) resulting in a $0 credit at $13,460 of earnings ($18,470 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2010 of 34 percent of their earnings up to $8,970, resulting in a maximum credit of $3,050. The maximum credit is available for those with earnings between $8,970 and $16,450 ($21,460 if married filing jointly). The credit begins to phase out at a rate of 15.98 percent of earnings above $16,450 ($21,460 if married filing jointly). The credit is completely phased out at $35,535 of earnings ($40,545 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2010 of 40 percent of earnings up to $12,590, resulting in a maximum credit of $5,036. The maximum credit is available for those with earnings between $12,590 and $16,450 ($21,460 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above $16,450 ($21,460 if married filing jointly). The credit is completely phased out at $40,363 of earnings ($45,373 if married filing jointly).

A temporary provision enacted by the American Recovery and Reinvestment Act of 2009[162] ("ARRA") allows taxpayers with three or more qualifying children to claim a credit of 45 percent for 2009 and 2010. For example, in 2010 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $12,590, resulting in a maximum credit of $5,666. The maximum credit is available for those with earnings between $12,590 and

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[160] A foster child must reside with the taxpayer for the entire taxable year.

[161] All income thresholds are indexed for inflation annually.

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

$16,450 ($21,460 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above $16,450 ($21,460 if married filing jointly). The credit is completely phased out at $43,352 of earnings ($48,362 if married filing jointly).

Under another provision of ARRA, the phase-out thresholds for married couples were raised to an amount $5,000 above that for other filers for 2009 (and indexed for inflation). The increase is $5,010 for 2010. Formerly, the phase-out thresholds for married couples were $3,000 (indexed for inflation from 2008) greater than those for other filers as provided for in EGTRRA.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

Description of Proposal

The proposal permanently extends the EITC at a rate of 45 percent for three or more qualifying children.

The proposal permanently extends the higher phase-out thresholds for married couples filing joint returns enacted as part of ARRA.

Effective date.−The proposal applies to taxable years beginning after December 31, 2010.

Analysis

Proponents argue that the EITC is generally structured to provide greater tax benefits to families with more children, and thus they believe it is appropriate to extend the additional benefits that were recently made available on a temporary basis to larger families with three or more children.

A “marriage penalty” exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. Large marriage penalties exist in the earned income credit, primarily because the ranges of earned income over which the credit is phased in and phased out are not adjusted for marital status (other than the one provision that delays the phase-out of the credit for married taxpayers). Proponents argue that extending the higher phase-out thresholds for married taxpayers filing jointly thus reducing marriage penalties is particularly important for this low-income households so that credit recipients are not discouraged from marrying on account of the loss or reduction in credit that marriage could entail.

Some opponents may argue that the combined expansions above provide the earned income tax credit to individuals who some may not consider low- or moderate-income taxpayers since eligibility for the credit can extend past $48,000[163] of income.

Prior Action

A similar provision was included in the President's fiscal year 2010 budget proposal.

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[163] Median U.S. family income in the U.S. in 2008 was $61,521. See U.S. Census Bureau, Historical Income Tables - Families, Table F-6, available at http://www.census.gov/hhes/www/income/histinc/incfamdet.html.

B. Expand the Child and Dependent Care Tax Credit

Present Law

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 35 percent of a limited amount of employment-related dependent care expenses. Eligible child and dependent care expenses related to employment are limited to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals. The applicable dollar limit is reduced by any amount excluded from income under an employer-provided dependent care assistance plan. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income above $15,000. Thus, for taxpayers with adjusted gross income above $43,000, the credit rate is 20 percent. The phase-out point and the amount of expenses eligible for the credit are not indexed for inflation.

Generally, a qualifying individual is: (1) a qualifying child of the taxpayer under the age of 13 for whom the taxpayer may claim a dependency exemption, or (2) a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapacitated, and shares the same principal place of abode with the taxpayer for over one half the year. Married taxpayers must file a joint return in order to claim the credit.

After 2010, the maximum credit will fall, and other parameters of the child and dependent care credit will change, as a result of the sunset provisions of EGTRRA.[164]

Description of Proposal

Under the proposal, the AGI level at which the credit rate begins to phase down is increased from $15,000 to $85,000. Thus, the credit rate is decreased by one percentage point for every $2,000 (or part thereof) of AGI over $85,000 until the percentage reaches 20 percent (at incomes above $113,000). As under current law, there are no further income limits and the phase-out point and the amount of expenses eligible for the credit is not indexed for inflation.

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

Analysis

By increasing the income levels at which the credit rate begins to phase down, the proposal increases the effective credit rate for eligible child and dependent care expenses by up to 15 percentage points (yielding a $900 maximum credit increase) for a substantial number of taxpayers. As a result, the proposal reduces the tax burden for workers with employment-related

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[164] A separate budget proposal, described in section II.I of this pamphlet, provides for the removal of the EGTRRA sunset.

child care expenses. Additionally, by increasing the after-tax return to employment for non-working individuals with child care responsibilities, the proposal could encourage these individuals to seek work outside of the home.

All taxpayers with qualifying expenses and AGI between $15,000 and $113,000 would experience an increase in their credit rate, but to varying degrees. Taxpayers with AGI between $43,000 and $85,000 would experience a rise in their credit rate from 20 percent to 35 percent. Taxpayers formerly in the phasedown range (those with AGI between $15,000 and $43,000), who thus had credit rates between 20 percent and 35 percent, would have their credit rate increased to 35 percent. Taxpayers in the new phasedown range (those with AGI between $85,000 and $113,000) would have credit rates between 20 percent and 35 percent, up from 20 percent previously. Taxpayers experiencing the full increase in the credit rate would experience an increase in their potential credit of $450 (from 20 percent of $3,000 to 35 percent of $3,000) for one qualifying child or $900 for two or more qualifying children (from 20 percent of $6,000 to 35 percent of $6,000).

The proposal represents a substantial expansion of the child and dependent tax credit, and if such significant changes to the credit are contemplated by Congress, consideration could be given to other or additional alterations to the credit. For example, an increase in the cap on qualifying expenses would assist those with greater child care expenses, such as those who work full time and/or live in high cost areas. Raising the cap could occur in addition to the contemplated changes to the credit rate or in lieu of them. For the same budgetary cost as the proposal, the caps could be raised with some paring back of the proposed increases to the credit rate. Consideration could also be given to indexing the cap on qualifying expenses and the AGI threshold for the phasedown of the credit rate. Lastly, as the credit is designed to help offset certain costs of earning income, consideration could be given to whether a deduction is the more appropriate tax treatment for an employment-related expense when the tax rate structure is progressive.

Prior Action

None.

C. Automatic Enrollment in Individual Retirement Arrangements

Present Law

Contribution limits

In general

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[165] to which both deductible and nondeductible contributions may be made,[166] and Roth IRAs, to which only nondeductible contributions may be made.[167] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income. For a Roth IRA, all contributions are after-tax (no deduction is allowed) but, if certain requirements are satisfied, distributions are not includable in gross income.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth IRAs) for a taxable year is the lesser of a certain dollar amount ($5,000 for 2010)[168] or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by $1,000. Thus for example, if an individual over age 50 contributes $6,000 to a Roth IRA for 2010 ($5,000 plus $1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for the year. In addition, deductible contributions to traditional IRAs and after tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI for the taxable year over certain indexed levels. In the case of an individual who is an

[165] Sec. 408.

[166] Sec. 219.

[167] Sec. 408A.

[168] The dollar limit is indexed for inflation.

active participant in an employer-sponsored plan, the AGI phase-out ranges for 2010 are: (1) for single taxpayers, $56,000 to $66,000; (2) for married taxpayers filing joint returns, $89,000 to $109,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2010 between $167,000 and $177,000.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions, including catch-up contributions. An individual who has attained age 70½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2010 are: (1) for single taxpayers, $105,000 to $120,000; (2) for married taxpayers filing joint returns, $167,000 to $177,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be kept in completely separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert a traditional IRA into a Roth IRA.[169] The amount converted is includible in income as if a withdrawal had been made,[170] except that the early distribution tax (discussed below) does not apply. However, the early distribution tax is recouped if the taxpayer withdraws the amount within five years of the conversion.

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date

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[169] For taxable years beginning prior to January 1, 2010, taxpayers with modified AGI in excess of $100,000 and married taxpayers filing separate returns were generally not permitted to convert a traditional IRA into a Roth IRA. Under the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, these limits on conversion are repealed for taxable years beginning after December 31, 2009.

[170] A special rule is provided in the case of a rollover in 2010. In such case, unless the taxpayer elects otherwise, the amount includible in income as a result of the conversion is included in income ratably in 2011 and 2012.

for the individual's income tax return for that year.[171] In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan). The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.[172]

Excise tax on excess contributions

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.[173] This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.[174] To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

Taxation of distributions from IRAs

Traditional IRAs

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis in the contract in the form of nondeductible contributions or rolled over after tax employee contributions. All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all the individual's traditional IRAs.

Roth IRAs

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of

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171 Sec. 408A(d)(6).

172 Treas. Reg. sec. 1.408A-6.

173 Sec. 4973(b) and (f).

174 Sec. 408(d)(4).

contributions to the Roth IRA are not includable in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions (including contributions rolled over from other Roth IRAs); (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. Thus, nonqualified distributions from all Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

Early distribution tax

Early withdrawals from an IRA generally are subject to an additional tax.[175] This additional tax applies to distributions from both traditional and Roth IRAs. The tax is calculated by reference to the amount of the distribution that is includable in AGI.[176] Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent tax unless another exception applies. Other exceptions include for withdrawals: due to death or disability; made in the form of certain periodic payments; used to pay medical expenses in excess of 7.5 percent of AGI; used to purchase health insurance for certain unemployed individuals; used for higher education expenses; used for first-time homebuyer expenses of up to $10,000; or made to a member of a reserve unit called to active duty for 180 days or longer.

Deemed IRAs

Certain types of employer-sponsored retirement plans are essentially allowed to provide IRAs to employees as a part of the employer-sponsored retirement plan. This option is available to tax qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional or Roth IRA.[177] Implementing the basic provision that the account satisfy the requirements to be an IRA, Treasury regulations require that the trustee with respect to the account be a bank or a nonbank trustee approved by the IRS.[178]

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[175] Sec. 72(t).

[176] Because distributions from Roth IRAs attributable to contributions (includible conversion contributions) are not includible in gross income and distributions from all Roth are treated as first attributable to contributions, the early-distribution tax generally will only apply to a distribution from a Roth IRA when only amounts attributable to earnings remain in all Roth IRAs. However, as noted earlier, a special rule applies for withdrawals within five years of a conversion.

[177] Sec. 408(q).

[178] Treas. Reg. sec. 1.408(q)-1.

Payroll deduction IRA

Under current law, an employer is permitted to establish a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997, Congress indicated that "employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs."[179] Congress encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs."[180] In response to that directive, the IRS published Announcement 99-2,[181] which reminds employers of the availability of this option for their employees.

In 1975, the Department of Labor ("DOL") issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to the Employee Retirement Income Security Act ("ERISA").[182] Interpretive Bulletin 99-1[183] restated and updated the DOL's positions on these programs. Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees and must otherwise make clear that that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee's savings.[184]

Employer retirement plans using IRAs

SIMPLE IRA plan

Under present law, a small business that employs fewer than 100 employees who earned $5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE retirement plan is generally a plan under which contributions are made to an

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179 Pub. L. No. 105-34.

180 H. Rep. No. 102-220, at 775 (1997).

181 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

182 Labor Reg. sec. 2510.3-2(d).

183 64 F.R. 32999, June 18, 1999; Labor Reg. sec. 2509.99-1.

184 Labor Reg. sec. 2509.99-1.

individual retirement arrangement for each employee (a "SIMPLE IRA").[185] A SIMPLE retirement plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of $11,500 (for 2010). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE retirement plan up to a limit of $2,500 (for 2010).

In the case of a SIMPLE retirement plan, the group of eligible employees generally must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year. A SIMPLE retirement plan is not subject to the nondiscrimination rules generally applicable to tax qualified retirement plans.

Employer contributions to a SIMPLE IRA must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. The employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation); however, a lower percentage cannot be elected for more than two years out of any five year period.[186] Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of each eligible employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.

The employer must provide each employee eligible to make elective deferrals under a SIMPLE retirement plan a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.[187]

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE retirement plan, and the employer may not maintain any other qualified retirement plan.

Simplified employee pensions

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to tax qualified defined contribution plans ($49,000 for 2010). All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during

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[185] There is also an option to provide a SIMPLE plan as part of a section 401(k) plan (a "SIMPLE section 401(k)" plan). In the case of a SIMPLE section 401(k) plan, the group of employees eligible to participate must satisfy the minimum coverage requirements generally applicable to qualified retirement plans under section 410(b). A SIMPLE section 401(k) plan does not have to satisfy the ADP or ACP test and is not subject to the top-heavy rules. The other qualified retirement plan rules generally apply.

[186] This option is not available for SIMPLE section 401(k) plans.

[187] Notice 98-4, 1998-1 C.B. 269.

at least three of the immediately preceding five years, and (3) received at least $550 (for 2010) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of SIMPLE retirement plans. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($16,500 for 2010). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of $5,500 (for 2010).

Automatic enrollment

Under a section 401(k) plan, employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as "elective deferrals" or "elective contributions." A section 401(k) plan may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make contributions to the section 401(k) plan. Alternatively, a plan may provide that elective contributions are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (i.e., affirmatively elects not to make contributions or to make contributions at a different rate). Arrangements that operate in the second manner are sometimes referred to as "automatic enrollment" plans.

In a section 401(k) plan, the employee must have an effective opportunity to elect to receive cash in lieu of contributions. Treasury regulations provide that whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.[188]

Pension Protection Act of 2006

The Pension Protection Act of 2006 ("PPA")[189] added a number of special rules to the Code and ERISA with respect to automatic enrollment in section 401(k) plans as well as section 403(b) plans and section 457(b) plans. Use of any of the special rules is predicated on a default contribution that is a stated percentage of compensation which applies uniformly to all participants. In addition, a notice must be provided to participants explaining the choice between making or not making contributions and identifying the default contribution rate and investment,

[188] Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

[189] Pub. L. No. 109-280.

and each participant must be given a reasonable period of time after receipt of the notice to make an affirmative election with respect to contributions and investments.

PPA also made changes to ERISA to permit the DOL to provide a safe harbor default investment option and to preempt State laws if certain requirements are satisfied.[190] Specifically, PPA amended ERISA to provide that a participant in an individual account plan with automatic enrollment is treated as exercising control over the assets which in the absence of an investment election are invested in accordance with regulations prescribed by the Secretary of Labor.

Under the DOL's PPA regulations, which were issued October 24, 2007, the default investment option for those automatically enrolled must be a qualified default investment alternative ("QDIA").[191] The choices for a QDIA include: (1) a product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund); (2) an investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally-managed account); (3) a product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund); and (4) a capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax). In addition, a QDIA must be managed by an investment manager, plan trustee, plan sponsor, a committee comprised primarily of employees of the plan sponsor that is a named fiduciary, or an investment company registered under the Investment Company Act of 1940. Further, a QDIA generally may not invest participant contributions in employer securities.

Tax credit for small employer plan pension start-up costs

Present law provides for a tax credit under section 45E for small employer plan pension start-up costs for the first three years of the plan. The credit is limited to the lesser of $500 per year or 50 percent of the start-up costs for a qualified plan meeting the requirements of section 401(a), an annuity plan described in 403(a), a SEP or a SIMPLE retirement plan. Start-up costs associated with a payroll deduction IRA are not eligible for the tax credit.

Description of Proposal

Automatic payroll deduction IRA program

Under the proposal, employers that have been in existence for at least two years, have more than 10 employees, and do not sponsor a qualified retirement plan for their employees would be required to offer an automatic enrollment payroll deduction IRA program to their

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[190] Sec. 514 of ERISA.

[191] Labor Reg. sec. 2550.404c-5.

employees ("automatic payroll deduction IRA program"). If an employer sponsors a retirement plan, but excludes certain employees (other than excludable employees[192]) under the plan, the otherwise non-excludable employees must be offered the opportunity to participate in an automatic payroll deduction IRA program.

Employers offering an automatic payroll deduction IRA program would give employees a standard notice and election form informing them of the automatic payroll deduction IRA option and allowing them to elect to participate or to opt-out. For any employee who fails to make an affirmative election in writing under the payroll deduction IRA program, the proposal includes a default under which payroll deduction contributions for the employee automatically begin to be made to an IRA established for the employee. Under the proposal, the automatic enrollment contribution rate for employees who fail to make an affirmative election would be three percent of compensation (but not more than the IRA dollar limit for the year). Employees could opt for a lower or higher contribution rate up to the IRA dollar limit for the year. Employee contributions to automatic IRAs would qualify for the saver's credit under section 25B (to the extent the employee and the contributions otherwise qualify for the credit), and an employee's saver's credit[193] could be deposited to the IRA to which the eligible individual contributed.

Employers making automatic payroll deduction IRAs available would not be responsible for opening IRAs for employees. Payroll deduction contributions from participating employees may be transferred, at the employer's option, to a single private sector IRA trustee or custodian designated by the employer or, if permitted by the employer, to the IRA provider designated by each participating employee. Alternatively, the employer could designate that all contributions would be forwarded to a savings vehicle specified by statute or regulation.

Similarly, employers would not be responsible for choosing or arranging default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed. The proposal generally does not involve employer contributions, employer compliance with plan qualification requirements, or employer liability under ERISA. A national web site would provide information and basic educational material regarding saving and investing for retirement, including IRA eligibility, but, as under current law, individuals (not employers) would bear ultimate responsibility for determining their IRA eligibility.

Under the proposal, the default under an automatic payroll deduction IRA program is a Roth IRA, though employees may elect to direct their contributions to a traditional IRA. The proposal also specifies a number of administrative requirements that must be satisfied, including

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[192] Under the proposal, excludable employees are employees excluded from a qualified employer plan pursuant to section 410(b)(3) (allowing exclusion of nonresident aliens and certain employees included in a unit of employees covered by a collective bargaining agreement) or to section 410(b)(4) (allowing exclusion of employees under 21 or having less than one year of service).

[193] For a description of the proposed expanded saver's credit, see *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, p. 19.

a mandated notice of the right to opt out or contribute a different amount, an election period, and specific timing requirements for the employer to make contributions. However, administrative rules would be designed to minimize administrative costs.

An excise tax, equal to $100 for each participant to whom the failure relates, applies to the failure of any employer to satisfy the automatic IRA requirements for any year.

Tax credit for automatic payroll deduction IRA program start-up costs

The proposal provides a tax credit for employers for the first two years in which the employer maintains an automatic payroll deduction IRA program. The amount of the credit is equal to $25 multiplied by the number of applicable employees for whom contributions are made, not to exceed $250 for the year.

The proposal also increases the tax credit under section 45E for small employer plan pension start-up costs from the current maximum of $500 per year for three years to $1,000 per year for three years. The increased credit does not apply to an automatic payroll deduction IRA program or other payroll deduction IRAs.

Effective date.−The proposal is effective January 1, 2012.

Analysis

In general

Advocates of this proposal argue that the proposal will promote retirement savings by employees who do not have access to an employer sponsored retirement plan. Advocates point out that the use of automatic enrollment increases employee participation in section 401(k) plans because providing contributions to the employee's account under the section 401(k) plan rather than cash in the employee's paycheck as a default takes advantage of the inertia of employees who fail to take action and simplifies the process for employees by eliminating the need for employees to make decisions as to the rate of contribution or the investment of the contributions.[194] They argue that this same inertia will increase saving in IRAs if employers are required to automatically enroll employees in payroll deduction IRAs. In addition, employees would not need to make a decision as to the financial institution at which to establish an IRA or whether to contribute to a Roth or traditional IRA. Advocates for the proposal also argue that an employer mandate for automatic IRAs will involve little cost to employers because the employer

[194] James J. Choi; David Laibson; Brigitte C. Madrian and Andrew Metrick; "For Better or Worse: Default Effects and 401(k) Savings Behavior," NBER Working Paper No. W8651. The authors studied three firms that adopted automatic enrollment in their section 401(k) plan. They comment on the effect as follows at 5. "We find that automatic enrollment has a dramatic effect on participation rates. Under automatic enrollment, 401(k) participation rates exceed 85% in all three companies regardless of the tenure of the employee. Prior to auto enrollment, 401(k) participation rate ranged from 26-43% after six months of tenure at these three firms and from 57-69% after three years of tenure."

is merely a conduit for the IRA contribution, similar to direct deposit of an employee's paycheck to the employee's bank account.[195]

Potential employee behavior

In addition to producing a general increase in participation comparable to that associated with automatic enrollment in section 401(k) plans, advocates for the proposal believe that mandatory automatic payroll deduction IRAs can be expected to increase contributions to IRAs by low-income and middle-income employees in particular.[196] They believe that, once these employees actually begin the "habit" of retirement savings, they are likely to continue to make contributions. The theory is that to the extent that these employees are not saving for retirement due to inertia (simple failure to take initiative), that same failure to take initiative may prevent them from electing out of the automatic contributions. By requiring an affirmative decision not to save in order to stop the contributions, advocates argue the proposal, at a minimum, would force employees to think about retirement savings. In the case of employees who can and want to save for retirement, the proposal will simplify implementing this decision. Advocates also point out that the use of payroll deduction means the individual is not required to come up with a substantial amount of funds at a single time to meet minimum deposit requirements imposed by many financial institutions offering IRAs. However, many financial institutions require no more than $500 to open an IRA, which is not necessarily substantial. This requirement could be satisfied if an individual saves $40 a month during the year and then opens the account with this savings.

Others point out that there is also evidence that lower-income and middle-income employees participating in present law section 401(k) plans with automatic enrollment who do not opt out of contributing are the most likely to remain at the default contribution rate rather than electing a higher contribution rate.[197] Advocates respond that proposed changes to the savers credit, which provide for a fully refundable credit to be deposited automatically in certain retirement accounts, including IRAs, may work in conjunction with the proposal in increasing participation, and contribution rates above the default rate, by low-income and middle-income individuals. They also point out that many who remain at the default rate might not have elected to participate at all without the automatic feature.

Nevertheless, some argue that certain employees currently do not save for retirement because they need all of their income to meet their basic needs, or retirement savings may be trumped by current savings, or repayment of loans, or for other purposes, such as the purchase of

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[195] J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs" at 49, Peter Orszag, J. Mark Iwry, and William G. Gale, ed. *Aging Gracefully: Ideas to Improve Retirement Security in America*, The Century Foundation Press, New York (2006).

[196] Choi, Laibson, Madrian, and Metric, at 22 found that "automatic enrollment [in section 401(k) plans] does increase wealth accumulation in the lower tail of the wealth distribution by dramatically reducing the fraction of employees that do not participate in the 401(k) plan."

[197] Choi, Laibson, Madrian, and Metric, at 17 found that "relative to employees in the top third of the pay distribution, employees in the bottom and middle of the pay distribution are much more likely to be at the default."

a home or a durable good (e.g., an automobile). They also argue that other employees may choose to spend their current income to finance a lifestyle that they wish to maintain. They point out that an automatic IRA may not change this behavior, especially to the extent that it is easy for an individual to opt out of participation; however, one empirical study found the likelihood of opting out to be small.[198] Opting out may be particularly likely in the case of individuals who are already in a negative savings position.

Some argue that automatic enrollment in payroll deduction IRAs is not likely to raise the same employee liquidity concerns that are associated with automatic enrollment in section 401(k) plans due to the distribution restrictions under 401(k) plans,[199] making it less likely that employees will elect out of automatic enrollment under a payroll deduction IRA program. For example, contributions to an IRA for a year are permitted to be withdrawn from an IRA (with allocable income) without tax consequence until the individual's due date for filing the income tax return for the year.[200] Even after that the deadline, amounts can be withdrawn, although the early distribution tax may apply for distributions before age 59½. In addition, unlike section 401(k) plan contributions, a payroll deduction contribution to a traditional IRA is deductible without regard to the timing of the election to make the contribution.

Some argue that the ultimate success of an automatic payroll deduction IRA program is not only how much money employees contribute to IRAs through the program, but how much is retained as savings for use in retirement. Others point out that there may be social benefits from pure savings, regardless of whether they are used in retirement. National savings may increase as a result; individuals can be better prepared for unanticipated expenses or changes in their financial situation, such as a job loss. However, national saving does not necessarily increase under the proposal to the extent that other planned saving is diverted into the automatic IRA. Others point out that savings alone do not provide for a secure retirement if the savings are not retained for consumption during retirement.

Historically, there have been significant withdrawals over time from IRAs, as reflected in the distributions made that are subject to the early distribution tax.[201] These withdrawals do not

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[198] This opt out may not be as likely as one might expect. In James J. Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," Edward J. McCaffery and Joel Slemrod, *Behavioral Public Finance,* Ed. Russell Sage Foundation, 2006, 304-351, the authors found that, before automatic enrollment 1.9 to 2.6 percent of employees who enrolled drop enrollment in a 12 month period, but the increased rate of dropping for a plan with automatic enrollment was only 0.3 to 0.6 percentage points higher than that for a plan without automatic enrollment.

[199] Sec 401(k)(2) provides that distributions from a section 401(k) plan are generally only permitted after the employee attains age 59 1/2 (or after death, due to disability, or after severance from employment, if earlier). However, elective contributions to a section 401(k) plan may be distributed on account of hardship.

[200] This unwind of contributions is permitted under section 408(d)(4).

[201] Based on tabulations of tax return data, in 2005, there were about 2.2 million returns with primary and secondary taxpayers age 59 and younger who had taxable IRA distributions. These taxpayers had taxable IRA and pension distributions of about $30 billion. About 1.2 million of these returns were subject to the additional 10-percent tax on over $13.2 billion of early distributions. Stated differently, about 56 percent of the number of taxable

include distributions made pursuant to an exception to the tax. Opponents of the proposal argue that those forced to save through the inertia of automatic enrollment may be more likely to take distributions even if they are required to pay the 10-percent early distribution tax. In the case of a Roth IRA, to the extent that only the amount of contributions is withdrawn, any tax-based deterrent to withdrawal is reduced because the distributed amounts are not includable in gross income or subject to the 10-percent early distribution tax. Others respond that a counter-balance against withdrawal from an IRA, in contrast to withdrawal from a section 401(k) account, is that there is no natural withdrawal event, such as termination from employment, which is likely to precipitate a withdrawal. Thus, inertia also may help keep the funds in the IRA.

Potential employer behavior

Some argue that the success of the program may depend, at least in part, on how it is received by employers. The employers that would be required to establish an automatic IRA program are generally employers that do not currently sponsor any retirement plan for their employees.

Advocates for the proposal argue that, for some employers, the failure to offer a plan may be the result of the same inertia that causes employees to fail to set up an IRA. They further argue that other employers may desire to establish a plan, but do not because of administrative cost or potential liability issues. For these employers, a mandated program may facilitate action that they already wanted to take. Advocates are optimistic that such participation may introduce these employers to retirement plan service providers who may in turn more easily induce them to set up an employer-sponsored retirement plan, such as a SIMPLE IRA plan or a section 401(k) plan.[202]

Not everyone agrees, however, with the argument that there will be little cost to employers. Some view the cost as being potentially significant. The ultimate cost to employers will likely depend on how the proposal is designed.[203] While the cost may be less significant than the cost associated with qualified employer plans, administrative costs and issues will be relevant in the establishment of an automatic IRA program. An employer will need to take action to establish a program. The employer will need to have a procedure for establishing

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IRA and pension distributions received by taxpayers 59 and younger with a taxable IRA distribution appear to have qualified for an exception from the additional early withdrawal tax.

[202] J. Mark Iwry and David C. John, at 71.

[203] Mary M. Schmitt and Judy Xanthopoulos, "Automatic IRAs: Are They Administratively Feasible, What are the Costs to Employers and the Federal Government, and Will They Increase Retirement Savings," Preliminary Report Prepared for AARP, Optimal Strategies, LLC, (March 8, 2007), 13. The report indicates that, in addition to cost to employers, costs associated with automatic IRAs to individual participants may erode the accounts significantly. However, in Mary M. Schmitt and Judy Xanthopoulos, "Administering Automatic IRAs," Report Prepared for AARP, Optimal Strategies, LLC, (October 17, 2007), the authors discuss how the costs can be reduced depending on how the proposal is implemented. In Mary M. Schmitt and Judy Xanthopoulos, "Most Small Employers Face Low Costs to Implement Automatic IRAs," Optimal Strategies, LLC (June 24, 2009), the authors point out that automatic payroll systems would reduce cost of automatic IRAs and that most small employers now use automated payroll systems.

default IRAs for employees and must institute notice procedures to inform employees that automatic enrollment will occur absent their affirmative election. In addition, the employer must have resources to address employee concerns and questions about the program. In response to these arguments, the proposal is designed to minimize these administrative costs, but will not eliminate them entirely. It also provides a tax credit with a maximum of $250 for the first two years for small employers to reduce this cost. Some have noted, however, that this tax credit, similar to most business tax credits (including the present law credit for small employer plan start up costs), will be of no benefit to small employers who are tax-exempt or who do not have a Federal tax liability for a given year (except to the extent the employer can use the permitted carry forward).

Advocates of the proposal recognize that the success of the program depends on streamlining compliance requirements for employers so that the cost of compliance is relatively low, and that success may depend on the implementation of the program by the Internal Revenue Service or other responsible agency. Advocates argue that the proposal is designed to be as administratively streamlined as possible, including a provision under which employers will not be required to open IRAs on behalf of employees. They point out that the proposal indicates that a low-cost standard default investment will be provided, which will help to lower employer cost of administration because the employer will not need to select a default investment and will limit the employer's potential liability for a poor choice.

Opponents argue that some employers may have made a conscious decision not to maintain an employer sponsored retirement plan for their employees. Under current law, other than withholding and paying payroll taxes to fund social security benefits, sponsorship of a retirement plan by an employer is voluntary. Opponents argue that the low level of voluntary establishment of payroll deduction IRA programs by employers who do not sponsor qualified retirement plans is not entirely due to inertia. An employer might have made a judgment that further payroll deductions of any kind, let alone an automatic program, is not a program that their employees, particularly minimum wage employees, would value. The employer might assume that these employees will not be able to afford any further reduction in take-home pay.

Some argue that the mandatory element of the proposal might generate resentment by certain employers and resistance to embracing the program as a benefit for their employees. They argue that the level of compliance among these employers may depend on the level of enforcement by the IRS. They further point out that an employer could present the option to employees in a way that is more likely to generate an election not to contribute than an election to make contributions.

Advocates of the proposal acknowledge that the program must be carefully designed so as not to result in the elimination or scaling back of existing employer-sponsored retirement plans, such as 401(k) or SIMPLE IRA plans, or the failure to adopt such plans. Some have argued that, because the proposal is designed to relieve employers of many of the burdens associated with sponsoring a qualified plan, small businesses may decide to limit employees' opportunity to save for retirement on a tax-favored basis to their ability to contribute to the automatic IRA program. Because the limits on contributions to the program are lower than those that apply to contributions to other qualified plans, this would have a negative impact on the amount of retirement savings some individuals would otherwise accumulate under an employer-sponsored plan.

Others have noted, however, that the desire of small business owners to take advantage of the greater tax-deferred savings offered under a qualified plan (allocations up to $49,000 for 2010 are permitted) will continue to provide an incentive to sponsor such plans, regardless of any relative cost savings associated with offering only the automatic IRA program. The rules prohibiting discrimination in favor of owners and other highly compensated employees prevent small-business owners from taking advantage of this higher limit on contributions without providing benefits for rank and file employees. Finally, the proposal doubles the current start-up cost credit available under section 45E to $1,000 per year for three years. Advocates believe that this expanded credit will encourage small employers to adopt a new employer-sponsored retirement plan, rather than an automatic IRA program.

Financial institutions

In the absence of a proposal that mandates a Federal or State program to accommodate the new small IRAs that will be established, some argue that the financial community would need to embrace the program to make it feasible. Many of the employees who elect, or default into, participation will have no preexisting IRAs. Some will have no current relationship with any financial service provider. For low-income and middle-income employees, the initial contributions will be very small. For example, three percent of weekly pay of $500 is only $15. Most financial institutions charge small annual fees for IRA maintenance and many require minimum contributions to establish an IRA.[204] These fees and minimums may be a significant barrier to making default IRAs attractive to low-income or even middle-income taxpayers. Thus, even advocates of the proposal recognize that providing low-cost options as suggested in the proposal may be a critical element in a successful program.

Paternalism

The proposal makes mandatory an option that is already available under present law. Individuals are free to contribute to IRAs, subject to certain qualifications, and employers are free to establish payroll deduction IRAs. Employers may even be able to enroll employees in payroll deduction IRAs automatically under PPA changes to ERISA.[205] However, the proposal simplifies some of these opportunities. Proponents have expressed the belief that targeted individuals save insufficiently for retirement despite these opportunities. By mandating automatic enrollment, proponents hope to increase the take up rate of IRAs among the targeted employees in a way that they believe will improve their well being. Some make a case for paternalistic intervention on the grounds that individuals do not act in their own best interest

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[204] *Ibid.* at 44. The report discusses the problem of small automatic IRA contributions including current minimum monthly contributions and annual administrative fees. The report suggests pooling of automatic contributions to reduce administrative fees with respect to automatic accounts.

[205] Under present law, this level of employer involvement may constitute an endorsement of the default IRA and cause the automatic payroll deduction IRA program to be a pension plan under ERISA.

because of limits on individual rationality, a lack of information, or inertia.[206] Some argue that setting the default rule to contribute to an IRA with the ability to opt out, as opposed to the default rule being nonparticipation with the option of affirmative action to contribute, may be viewed as an example of soft, or libertarian, paternalism.[207] Advocates define paternalism as choosing a policy with the goal of influencing the choices of affected parties in a way that will make those parties better off, and such paternalism is libertarian if no coercion is involved. Others would argue that only voluntarily entered rules are free from coercion.[208] One might view the desirability of a policy differently, or hold it to a higher standard to judge its desirability, if coercion is involved. Some argue that "flaws in human cognition," such as those identified above, "should make us more, not less, wary about trusting government decisionmaking" and that while "soft paternalism is less damaging than hard paternalism….[, s]oft paternalism is neither innocuous or obviously benign."[209]

<u>Protection of employees against employer retaining deducted contributions</u>

The DOL has found numerous instances where employers have deducted amounts from an employee's pay for contribution to a section 401(k) plan but failed to contribute the amount to the plan.[210] In the case of a section 401(k) plan, such failure can result in excise taxes, civil penalties, and even criminal prosecution.[211] The DOL has found that the employee may not be aware that the contributions are not being made until the employee receives his or her account

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[206] H. Rep. 109-232 Part 1 that accompanied H.R. 2830 (September 22, 2005), at 280.

[207] *See* Richard H. Thaler and Cass R. Sunstein, "Libertarian Paternalism," *American Economic Review Papers and Proceedings*, 93, May 2003, pp. 175-179.

[208] See Daniel B. Klein, "Statist Quo Bias," *Econ Journal Watch*, 1(2), August 2004, pp. 260-271, Cass R. Sunstein "Response to Klein," *Econ Journal Watch*, 1(2), August 2004, pp. 272-273, and Daniel B. Klein, "Reply to Sunstein," *Econ Journal Watch*, 1(2), August 2004, pp. 274-276.

[209] Edward L. Glaeser, "Paternalism and Psychology," *University of Chicago Law Review*, 73, (2006), pp. 133-156, at 133, 135.

[210] Since 1995, the DOL has emphasized 401(k) abuse as a national enforcement initiative. The DOL reports the following 401(k) enforcement initiative results for fiscal years 2007 and 2008: for fiscal year 2008, a total of 1,232 civil investigations were closed, with 1,072 corrected violations and monetary results of $24,863,198 nationwide; for fiscal year 2007, 1,326 civil and criminal investigations were closed with 1,133 corrected violations and monetary results of $51,294,250 nationwide. Fact Sheet: Retirement Security Initiatives, U.S. Department of Labor, Employee Benefits Security Administration, http://www.dol.gov/ebsa/erisa_enforcement.html#section6.

[211] Under DOL Reg. sec. 2510.3-102, an amount withheld from an employee's wages for contribution to a section 401(k) plan becomes part of the assets of the pension plan for purposes of ERISA protections as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. An employer holding these assets after that date commingled with its general assets is engaging in a prohibited use of plan assets under section 406 of ERISA, which generally prohibits a plan fiduciary from engaging in prohibited transactions. The DOL has a correction program that allows employers to voluntarily correct violations under certain circumstances under its Voluntary Fiduciary Correction Program, published in the *Federal Register* on March 28, 2002 (67 FR 15061).

statement.[212] As a result, some argue that it is important that any proposal include comparable protection for employees to those provided to participants under a section 401(k) plan against these potential abuses by employers. One approach advocated by some is to mandate that all default contributions be made to a government-sponsored IRA and that all employees have a government sponsored IRA as an investment option. They argue that such a requirement could make it easier to establish a mechanism for regularly monitoring whether contributions were being made in a timely manner.

<u>Traditional or Roth IRA as the default</u>

Under the proposal, the default is a Roth IRA. The designation of Roth IRAs as a default removes one potential complexity for employers and employees, but may also have immediate and long-term tax consequences for employees. For example, as discussed above, the maximum contribution that can be made to a Roth IRA is phased out for taxpayers with AGI over certain levels (for 2010, for single taxpayers, \$105,000 to \$120,000, and for married taxpayers filing jointly, \$167,000 to \$177,000). There is no income limit for nondeductible contributions to a traditional IRA and no income limit for deductible contributions if the taxpayer (or, if married, both taxpayer and spouse) does not participate in an employer-sponsored plan. Thus, many argue that, to the extent no default is provided, an employer is likely to choose a traditional IRA as a default so that higher income employees will not be subject to excise taxes for excess contributions.

However, some argue that, for many taxpayers, a Roth IRA may be a better choice. Lower income taxpayers may have a lower marginal rate currently than when they receive distributions, making a deduction today for a traditional IRA less valuable and less of a motivation for retirement savings than would be the alternative exclusion for income from a Roth IRA in retirement. While it is generally the case that the lower one's income, the lower one's marginal tax rate, some lower income taxpayers can have a quite high effective marginal tax rate as a result of the phaseout of the earned income tax credit. These same taxpayers may face further increases in their effective marginal tax rates as a result of the phaseout of the newly-enacted tax credit for individuals and families who purchase health insurance through a State health insurance exchange. Hence, many low and middle income taxpayers might be better off if the default is a traditional IRA rather than a Roth IRA.

Additionally, lower income employees may prefer to contribute to a Roth IRA because funds in a Roth IRA may be distributed prior to retirement age with fewer penalties than distributions from traditional IRAs. Roth distributions are allocated first to basis and received tax free (and thus also not subject to the 10 percent early distribution tax) until all contributions are distributed. In contrast, any distribution attributable to deductible contributions is fully includible in gross income and subject to the early-distribution tax unless an exception applies.

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[212] For employees, the DOL includes on its website a list of 10 warning signs that 401(k) contributions are being misused. Examples of the warnings signs listed include the employee's account statement shows a contribution from a paycheck was not made and that the employer has recently experienced severe financial distress (http://www.dol.gov/ebsa/Publications/10warningsigns.html).

Finally, even for individuals who benefit from the ability to make deductible contributions to a traditional IRA (i.e., higher income employees), a contribution to a Roth IRA of the maximum amount (to the extent allowed by the income limits) will produce more income at retirement because a dollar contributed to a Roth account represents greater after-tax savings than a dollar contributed to a traditional deductible IRA, because the former is contributed on an after-tax basis while the latter is contributed on a pre-tax basis. Still, higher-income employees may be unable to make regular Roth contributions because of the income limits. In addition, taxpayers making contributions to a Roth IRA are required to include the amount of the contributions in AGI rather than being allowed to deduct it, further diminishing the individual's current after-tax disposal income, a potentially greater concern for lower income taxpayers.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.

D. Saver's Credit

Present Law

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[213] The maximum annual contribution eligible for the credit is $2,000 per individual. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2010, married taxpayers filing joint returns with AGI of $55,500 or less, taxpayers filing head of household returns with AGI of $41,625 or less, and all other taxpayers filing returns with AGI of $27,750 or less, are eligible for the credit. As the taxpayer's AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2010 are provided in Table 6, below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

Table 6.–Credit Rates for Saver's Credit

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0 – $33,500	$0 – $25,125	$0 – $16,750	50 percent
$33,501 – $36,000	$25,126 – $27,000	$16,751 – $18,000	20 percent
$36,001 – $55,500	$27,001 – $41,625	$18,001 – $27,750	10 percent
Over $55,500	Over $41,625	Over $27,750	0 percent

The saver's credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets alternative minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 years old or older, other than individuals who are full-time students or who are claimed as a dependent on another taxpayer's return.

The credit is available with respect to: (1) elective deferrals to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity (a "section 403(b)" annuity), an eligible deferred compensation arrangement of a State or local government (a "section 457 plan"), a savings incentive match plan for employees (a "SIMPLE"), or a simplified employee pension (a "SEP"); (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a tax-sheltered annuity or qualified retirement plan. Under the rules governing these arrangements, an individual's contribution to the arrangement generally cannot exceed the lesser of an annual dollar amount or the individual's compensation that is includible in income. In the case of any IRA contributions made by a married couple, the combined includible compensation of both spouses may be taken into account. In addition, for purposes of determining the IRA contribution limit, an individual's includible compensation is

[213] Sec. 25B(a).

determined without regard to the exclusion for combat pay.[214] Thus, excluded combat pay received by an individual is treated as includible compensation for purposes of determining the amount that the individual (and the individual's spouse) can contribute to an IRA.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer filed a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including extensions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not reduce the amounts of the taxpayer's contributions eligible for the credit.

Description of Proposal

The proposal makes the saver's credit fully refundable and provides for the credit to be deposited automatically in the qualified retirement plan account or IRA to which the eligible individual contributed.

In place of the current 10-percent/20-percent/50-percent credit for qualified retirement savings contributions up to $2,000 per individual, the proposal provides a credit of 50 percent of such contributions up to $500 (of contributions) per individual (indexed annually for inflation beginning in 2011). The income threshold for eligibility is increased to $65,000 for married couples filing jointly, $48,750 for heads of households, and $32,500 for singles and married individuals filing separately, with the amount of savings eligible for the credit phased out at a five-percent rate for AGI exceeding those levels.

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

Analysis

The current law saver's credit is intended to encourage low-income taxpayers to save by subsidizing the return to saving, but many have criticized its effectiveness.[215] The principal criticisms of the effectiveness of the saver's credit have focused on the low use of the credit, owing to: (1) its lack of refundability, (2) the complexity of the credit rate structure combined with taxpayer uncertainty regarding eligibility, (3) lack of awareness of the credit, and (4) the relatively low AGI thresholds for eligibility.

Those who have criticized the complexity of the credit rate structure note that many taxpayers will not know their precise AGI in order to know what their credit rate will be, or even

[214] Sec. 219(f)(7).

[215] See, for example, Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Savings Incentives For Low- And Moderate-Income Families In The United States: Why Is The Saver's Credit Not More Effective?," *Journal of the European Economic Association*, April - May 2007, 5(2-3).

to know if they will be eligible for any credit given that the credit amount drops precipitously to zero once the relevant AGI threshold is crossed. Others have observed that, because the credit is non-refundable, and the AGI eligibility thresholds fairly low, many taxpayers simply cannot benefit from the credit as they have no tax liability to offset.[216] By making the credit refundable and raising the income eligibility limits, the proposal is likely to increase utilization of the credit. Also, the revised structure should make it easier for most taxpayers to have a better sense of the amount of credit for which they will be eligible, which could increase use of the credit to the extent that existing uncertainly limits the use of the credit.

While many taxpayers are saving insufficiently for their future needs, some might criticize the saver's credit on the grounds that low-income taxpayers should not necessarily be encouraged to save (for example, a single parent with young children who is eligible for the saver's credit should probably devote available resources to current needs rather than forgoing current consumption in favor of saving). Others might argue that the public resources devoted to encouraging saving via this credit could be better used to meet unmet current needs of the low-income population in general, or those specifically of the elderly poor who have saved insufficiently for retirement.

As noted above, the President's proposal increases eligibility for the saver's credit by raising the AGI eligibility thresholds and making the credit refundable. As such, the proposal should be more effective at encouraging additional private saving, but at commensurate additional public cost. Additionally, while a payment to save in the form of a tax credit may encourage additional saving, some of the credit will be paid to those who are saving in any case.[217] If the loss in tax revenues (i.e., public dissaving) due to the credit is large relative to net additional private savings that result from the credit, national saving (the sum of private and public saving) might not increase much, or at all.

The present law saver's credit, as well as the proposed credit, condition credit eligibility on AGI. While use of AGI is a common way to limit eligibility based on economic need, consideration could be given to limiting eligibility using a better measure of a taxpayer's ability to save, such as taxable income (which accounts for the presence of dependents, for example). The current use of AGI might result in a disproportionate amount of the credit going to taxpayers with greater ability to save, while conditioning the credit on taxable income might better target the incentive at taxpayers with more similar ability to save.

Under the proposal, some taxpayers could be made worse off, because the amount of contributions eligible for the credit is reduced to $500 per individual, rather than present law's $2,000 limit. Thus, for example, an individual eligible for the 20 percent credit under present

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216 See Gary Koenig and Rob Harvey, "Utilization of the Saver's Credit: An Analysis of the First Year," *National Tax Journal* 58 No. 4 (December 2005). They note that, in an analysis of the first year of availability of the credit, 43 percent of taxpayers who claimed the credit at the maximum rate had their credit limited by their tax liability.

217 Similar criticisms are made of other savings incentives, such as the exclusion from income of contributions to employer-sponsored retirement plans.

law is potentially eligible for a credit of $400 (20 percent of $2,000), while under the proposal the maximum credit is 50 percent of $500, or $250. To the extent that the main purpose of the saver's credit is to encourage small amounts of retirement saving for those who might not otherwise do any saving, the proposed reorientation of credit resources might be appropriate. On the other hand, by lowering the maximum amount of savings that are subsidized, the marginal incentive to save amounts greater than that are reduced for taxpayers eligible for the subsidy under present law. By extending eligibility further up the income distribution, the proposal increases the marginal incentive to save for taxpayers currently saving less than $500 for retirement, though it provides a windfall and no additional incentive to save for taxpayers saving $500 or more for retirement.

The provision providing for the option to have the credit deposited into the retirement savings account of the taxpayer might also encourage additional saving. However, additional complexities could result for employers if they are required to set up mechanisms to accept the deposit of the tax credit to an employer plan. The administrative costs of such mechanisms may be disproportionately large for small credit amounts.

Additional complexities could result more generally for deposits of the tax credit into qualified retirement savings accounts. Depending how such direct deposits are treated, such direct deposits could reduce the magnitude of the credit available to the taxpayer, at least with respect to the tax year that gave rise to the credit. For example, a contribution of $200 to an IRA would generate a tax credit of $100, which, if the tax credit is directly deposited into the account, results in a net cost to the taxpayer of $200 for the total $300 that is contributed to the IRA. If, on the other hand, the taxpayer had contributed the full $300 to the IRA himself, the taxpayer would have been eligible for a $150 tax credit which, if paid directly to him, would imply a net cost to the taxpayer of only $150 for the $300 IRA. To the extent the directly deposited tax credit is allowed as a qualified retirement saving contribution for the taxable year in which the deposit actually occurs (which in general will be the taxable year following the taxable year that gave rise to the credit), the taxpayer would ultimately be able to claim a credit (and a deduction if otherwise allowed) for the contribution.

Other technical issues that need to be addressed include: (1) how direct deposit credit amounts would be allocated among qualified retirement plan accounts and IRAs for taxpayers that make qualified retirement savings contributions to more than one such account or arrangement, and (2) whether and how any credit amounts that are directly deposited into a taxpayer's qualified retirement plan account or IRA would count towards the annual contribution limits that apply to such accounts and arrangements.

Prior Action

A similar proposal was included in the President's Fiscal Year 2010 budget proposal.

E. Extend American Opportunity Tax Credit

Present Law

Hope credit

For taxable years beginning before 2009 and after 2010, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to $1,800 (for 2008) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[218] The Hope credit rate is 100 percent on the first $1,200 of qualified tuition and related expenses, and 50 percent on the next $1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. Thus, for example, a taxpayer who incurs $1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phaseout described below) for a $1,200 Hope credit. If a taxpayer incurs $2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a $1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $48,000 and $58,000 ($96,000 and $116,000 for married taxpayers filing a joint return) for 2008. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phaseout ranges are always $10,000 and $20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified

[218] Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2010.

tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.[219]

The Hope credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

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[219] The above-the-line deduction for qualified tuition and related expenses is not available for taxable years beginning after December 31, 2009. However, a separate proposal contained in the President's fiscal year 2011 budget extends this deduction for two years, so that it is available for taxable years beginning before January 1, 2012.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply.[220] The principal EGTRRA change scheduled to expire is the change that permits a taxpayer to claim a Hope credit in the same year that he or she claims an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

American opportunity tax credit

The American Opportunity Tax Credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009 or 2010. The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

Under the provision, the modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

Description of Proposal

The proposal expands the present law Hope credit so as to make permanent the temporary modifications to the Hope credit for taxable years beginning in 2009 and 2010 that are known as the American Opportunity Tax Credit. In addition, the proposal renames the Hope credit the American Opportunity Tax Credit.

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[220] A separate proposal contained in the President's fiscal year 2011 budget permanently extends the changes to the Hope credit made by EGTRRA. See Part IV.E. of this document for a description of that proposal.

The dollar amounts to which the 100-percent and 25-percent credit rates are applied are indexed for inflation, with the amounts rounded down to the next lowest multiple of $100. The AGI phaseout ranges are also indexed for inflation, with the amounts rounded down to the next lowest multiple of $1,000.

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

Analysis

The present-law modifications to the Hope credit, referred to as the American Opportunity Tax Credit, are intended to provide some financial relief to taxpayers faced with increasing tuition costs. The proposal makes the American Opportunity Tax Credit modifications permanent. By increasing the amount of the credit, the phaseout levels, and the number of years of education with respect to which the credit may be claimed, the modifications increase the number of taxpayers who may claim the credit and the amount of credit that those taxpayers may claim. In addition, because the modifications make a portion of the credit refundable, additional people (i.e., those with no Federal income tax liability) may benefit from the credit.

Some people observe that the cost of post-secondary education has increased at a rate in excess of the rate of inflation for nearly 30 years, with the result that it is becoming an ever greater financial burden for individuals to pursue a college education. These people contend that making the American Opportunity Tax Credit permanent will help to mitigate some of this burden. Other people observe that the acquisition of a college degree provides enormous benefits to an individual (e.g., greater lifetime earning potential and increased job opportunities) that are sufficient to justify the cost of acquiring the degree, and that these benefits have increased over time.[221] If the cost of obtaining a college degree were to exceed the resulting benefits, one would expect to see a decrease in the number of individuals pursuing a degree until such time as the costs decrease and/or the benefits increase. As of yet, such a decline in college attendance has not occurred.[222]

Other people argue that some individuals who desire to go to college are unable to do so because they do not have the funds to pay for the education and are unable to borrow the necessary amounts (because, for example, it is difficult to pledge increased future earning potential as security for a loan). For these potential students, a generous government subsidy in the form of the American Opportunity Tax Credit may make up for the deficiency in funding and enable them to pursue the college degree that they desire. In response to this argument, some people observe that there already exist a large variety of programs, available from both the public

[221] See, e.g., Thomas Lemieux, "Postsecondary Education and Increasing Wage Inequality," *American Economic Review* 96 (May 2006): 195-99.

[222] See Thomas D. Snyder, Sally A. Dillow, and Charlene M. Hoffman, National Center for Education Statistics, U.S. Department of Education, *Digest of Education Statistics 2008* (NCES 2009-020), March 2009, at 269, 296, *available at* http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2009020.

and private sectors, that are designed to help students to afford college, including various loan programs, merit-based assistance programs, and need-based assistance programs (e.g., the Pell Grant program).

Another aspect of the proposal that merits discussion is that it provides for permanent, partial refundability of the credit. Some argue that credits for education expenses should be refundable to subsidize education for low-income individuals who need the subsidy the most but may have insufficient tax liability to realize the benefit of the Hope credit (without the temporary modifications of the American Opportunity Tax Credit). Others argue that refundable tax credits are administratively complex and that there are Federal spending programs, such as the Pell Grant program, that provide direct grants for education to a demographic group of individuals that is generally similar to the group that would be eligible for the permanent, refundable credit.[223] They also argue that the Pell Grant has the advantage of providing its subsidy at the time the education expense is incurred, whereas a refundable credit, unless made advanced-refundable, would provide the subsidy after the education expenses are incurred when the tax return is filed and processed.[224]

Lastly, an issue that affects tax incentives, such as the American Opportunity Tax Credit, as well as direct expenditures to subsidize education, concerns the ultimate economic incidence of the subsidies as compared to the statutory beneficiary. For example, it has been observed that the various individual tax benefits for education (such as the present-law Hope credit) provide incentives for educational institutions to capture some of the benefit by raising their tuition and fees. This observation is particularly true for community colleges that charge less than the amount that is fully subsidized by the Hope credit (e.g., the first $1,200 of tuition in 2008 is eligible for a 100-percent credit for Hope eligible students), because tuition can be raised to $1,200 without the student paying more out of-pocket on an after-tax basis, provided the student or parent has tax liability to offset.[225] Additionally, State and local governments may choose to appropriate fewer funds to the public educational institutions or to financial aid programs in response to the increased support provided by the Federal government via individual tax incentives.[226] These responses by educational institutions and/or State and local governments

[223] In a separate, nontax proposal, the President's budget proposes to make the Pell Grant program a permanent entitlement (i.e., a mandatory spending program) and index the Pell Grant program to the Consumer Price Index plus one percent (the current maximum Pell Grant award available for the 2010-2011 school year is $5,550). Office of Management and Budget, *Analytical Perspectives: Budget of the U.S. Government: Fiscal Year 2011* (H. Doc. 111-82) (2010), vol. III, p. 152.

[224] The ability to obtain a loan from the educational institution or another source with the expected credit as security would mitigate this concern. However, some people have raised concerns about the high cost of some loans that are made in anticipation of tax refunds.

[225] For students who do not have income tax liability to offset, the college may offer additional scholarship amounts to offset the tuition increase so that these students pay the same out-of-pocket amount as they did before the college attempted to capture the subsidy.

[226] For evidence on the response of educational institutions with respect to tuition policy and governments with respect to appropriations for education, see Bridgett Terry Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in *College Choices: The Economics of Where to Go, When to Go, and How to Pay for It* 101 (Caroline M. Hoxby ed., 2004).

have the potential to undermine the benefit provided at the Federal level. In particular, to the extent that colleges raise tuition in response to a Federal nonrefundable (or only partially refundable) credit, students or parents without Federal tax liability to offset are unambiguously made worse off.

This last issue of who is the ultimate economic beneficiary of a particular tax benefit for education may be an even greater concern under the American Opportunity Tax Credit and the proposal to make it permanent because this credit provides an even larger subsidy than the present-law Hope credit. In particular, the American Opportunity Tax Credit increases the amount of tuition that is fully subsidized to $2,000 per year (from $1,200 in 2008). As a result of this change, a college that wishes to capture as much of the subsidy as possible may now have an incentive to raise tuition to at least $2,000. In addition, the American Opportunity Tax Credit substantially raises the income phaseout amounts. Thus, a college that wishes to capture as much of the subsidy as possible now may need to be less concerned that students will be ineligible for the credit (due to their high income) and face increased out-of-pocket costs—the vast majority of Americans have incomes below the new phaseout amounts. Finally, the American Opportunity Tax Credit makes 40 percent of the credit refundable. This change means that a college that wishes to capture as much of the subsidy as possible now may need to be less concerned that students will not benefit from the credit because they have no tax liability. In fact, a college that wishes to leave these students with no increased out-of-pocket costs (e.g., by providing increased scholarship amounts to offset subsidy-capturing tuition increases), may nevertheless be able to capture the refundable portion of the credit.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.

V. TAX CUTS FOR BUSINESSES

A. Increase Exclusion of Gain on Sale of Qualified Small Business Stock

Present Law

In general

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 more than five years.[227] The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[228] A percentage of the excluded gain is an alternative minimum tax preference;[229] the portion of the gain includible in alternative minimum taxable income ("AMTI") is taxed at a maximum rate of 28 percent under the alternative minimum tax ("AMT").

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[230] and under the AMT at (i) 14.98 percent for dispositions before January 1, 2011; (ii) 19.88 percent for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.[231]

The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

Special rules for certain stock issued in 2009 and 2010

For stock issued after February 17, 2009, and before January 1, 2011, the percentage exclusion for qualified small business stock sold by an individual is increased to 75 percent.

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[227] Sec. 1202.

[228] Sec. 1(h).

[229] 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.

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

[231] The amount of gain included in AMTI 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.

As a result of the increased exclusion, gain from the sale of qualified small business stock to which the provision applies is taxed at maximum effective rates of seven percent under the regular tax[232] and 12.88 percent under the AMT.[233]

Description of Proposal

Under the proposal all gain from the sale or exchange of qualified small business stock is excluded from gross income. The AMT preference is eliminated. Other current law limitations on exclusion and the requirement that the small business stock be held for five years continue to apply. Additional documentation is required to insure compliance with these limitations.

Effective date.−The proposal is effective for qualified small business stock acquired after February 17, 2009.

Analysis

For analysis of this proposal, as well as capital gains in general, see Analysis under "Dividends and Capital Gains Tax Rate Structure."

Prior Action

The American Recovery and Reinvestment Tax Act of 2009 provided the rule described under present law relating to stock issued after February 17, 2009, and before January 1, 2011.

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

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

B. Make the Research Credit Permanent

Present Law

General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[234] Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.[235]

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

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2009.[236]

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that

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[234] Sec. 41.

[235] Sec. 41(e).

[236] Sec. 41(h).

period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[237]

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[238] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands. Under these rules, qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.[239]

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.[240] If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental research credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year

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

[238] Sec. 41(f)(1).

[239] Sec. 41(f)(3).

[240] Sec. 41(c)(4).

research expenses exceed a base amount computed by using a fixed-base percentage of two percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above are increased to three percent, four percent, and five percent, respectively.[241]

An election to be subject to this alternative incremental research credit regime can be made for any taxable year beginning after June 30, 1996, and before January 1, 2009. Such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury. The alternative incremental credit regime is not available for taxable years beginning after December 31, 2008.

Alternative simplified credit

Generally, for amounts paid or incurred after 2006, taxpayers may elect to claim an alternative simplified credit for qualified research expenses.[242] The alternative simplified research credit is equal to 12 percent (14 percent for taxable years beginning after December 31, 2008) of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

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

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[243] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or

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[241] A special transition rule applies for fiscal year 2006-2007 taxpayers.

[242] A special transition rule applies for fiscal year 2006-2007 taxpayers.

[243] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[244] In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.[245] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[246] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[247] Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.[248]

Description of Proposal

The proposal makes the research credit permanent.

Effective date.−The proposal is effective for amounts paid or incurred after December 31, 2009.

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[244] Sec. 41(d)(3).

[245] Sec. 41(d)(4).

[246] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

[247] Sec. 280C(c).

[248] Sec. 280C(c)(3).

Analysis

Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm maybe cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace may improve overall economic efficiency.[249] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. However, there is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[250] Nevertheless, even if there were agreement that additional subsidies for research are warranted as a general matter, misallocation of research dollars across competing sectors of the economy could diminish economic efficiency. It is difficult to determine whether, at the present levels and allocation of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency.

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach the optimal level. Among the other policies employed by the Federal government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is relatively little consensus regarding the magnitude of the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should

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[249] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

[250] See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, vol. XCIV, (1992); M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993; and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude Barfield, editors, *Technology, R&D and the Economy*, (Washington, D.C.: Brookings Institution Press), 1996, pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." Griliches, p. S43. Charles I. Jones and John C. Williams, "Measuring the Social Return to R&D," *Quarterly Journal of Economics*, 113, November 1998, also conclude that "advanced economies like the United States substantially under invest in R&D" (p. 1120).

increase research activities beyond what they otherwise would be. However, the present law research credit contains certain complexities and compliance costs.

Scope of research activities in the United States and abroad

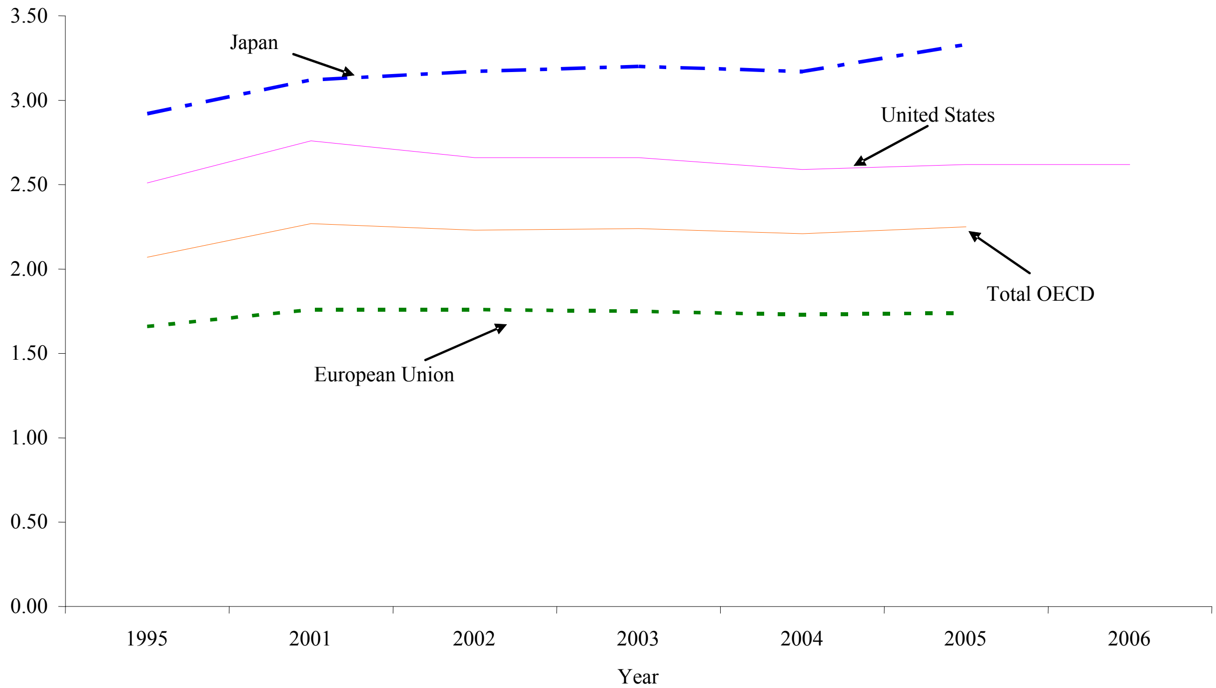
In the United States, private for-profit enterprises and individuals, non-profit organizations, and the public sector undertake research activities. Total expenditures on research and development in the United States are large, representing 2.6 percent of gross domestic product in 2005 and 2006.[251] This rate of expenditure on research and development exceeds that of the European Union and the average of all countries that are members of the Organisation for Economic Co-operation and Development ("OECD"), but is less than that of Japan. See Figure 1, below. In 2005, expenditures on research and development in the United States represented 42.2 percent of all expenditures on research and development undertaken by OECD countries, were 40 percent greater than the total expenditures on research and development undertaken in the European Union, and were more than two and one half times such expenditures in Japan.[252] Expenditures on research and development in the United States have grown at an average real rate of 3.69 percent over the period 1995-2005. This rate of growth has exceeded that of France (1.52 percent), the United Kingdom (1.86 percent), Japan (2.46 percent), Italy (2.50 percent), and Germany (2.57 percent), but is less than that of Canada (4.95 percent), Spain (7.34 percent), and Ireland (7.40 percent).[253]

[251] Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Scoreboard, 2007* (Paris: Organisation for Economic Co-operation and Development), 2007. This data represents outlays by private persons and by governments. The figures reported in this paragraph and Figure 1 do not include the value of tax expenditures, if any. The OECD calculates that the United States spent approximately $344 billion on research and development in 2006. Organisation for Economic Co-operation and Development, *Main Science and Technology Indicators, 2007*, vol. 2 (Paris: Organisation for Economic Co-operation and Development), 2007.

[252] OECD, *Science, Technology and Industry Scoreboard, 2007*. While the OECD attempts to present these data on a standardized basis the cross-country comparisons are not perfect. For example, the United States reporting for research spending generally does not include capital expenditure outlays devoted to research while the reporting of some other countries does include capital expenditures.

[253] OECD, *Main Science and Technology Indicators, 2007,* vol. 2. The annual real rate of growth of expenditures on research and development for the period 1995-2005 in the European Union and in all OECD countries was 2.94 percent and 3.61 percent, respectively. All reported growth rates are calculated in terms of U.S. dollars equivalents converted at purchasing power parity.

Figure 1.−Gross Domestic Expenditure on R&D as a Percentage of GDP, United States, Japan, the European Union, and the OECD, 1995-2005



Source: OECD, Main Science and Technology Indicators, 2007, vols. 1 & 2.

A number of countries, in addition to the United States, provide tax benefits to taxpayers who undertake research activities. The OECD has attempted to quantify the relative value of such tax benefits in different countries by creating an index that measures the total value of tax benefits accorded research activities relative to simply permitting the expensing of all qualifying research expenditures. Table 7, below, reports the value of this index for selected countries. A value of zero would result if the only tax benefit a country offered to research activities was the expensing of all qualifying research expenditures. Negative values reflect tax benefits less generous than expensing. Positive values reflect tax benefits more generous than expensing. For example, in 2008 in the United States qualifying taxpayers could expense research expenditures and, in certain circumstances, claim the research and experimentation tax credit. The resulting index number for the United States is 0.07.[254]

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[254] Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Outlook, 2008* (Paris: Organisation for Economic Co-operation and Development), 2008. The index is calculated as one minus the so-called "B-index." The B-index is equal to the after-tax cost of an expenditure of one dollar on qualifying research, divided by one minus the taxpayer marginal tax rate. Alternatively, the B-index represents the present value of pre-tax income that is necessary to earn to finance the research activity and earn a positive after-tax profit. In practice, construction of the B-index and the index number reported in Table 1 requires a number of simplifying assumptions. As a consequence, the relative position of the tax benefits of various countries reported in the table is only suggestive.

Table 7.−Index Number of Tax Benefits for Research Activities in Selected Countries, 2008

Country	Index Number[1]
Germany	-0.03
Italy	-0.02
Ireland	0.05
United States	0.07
United Kingdom	0.11
Japan	0.12
Canada	0.18
France	0.37
Spain	0.39

[1] Index number reported is only that for "large firms." Some countries have additional tax benefits for research activities of "small" firms.

Source: OECD, OECD Science, Technology and Industry Outlook, 2008.

Scope of tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit was estimated to be $4.9 billion for 2008. The related tax expenditure for expensing of research and development expenditures was estimated to be $3.1 billion for 2008, growing to $7.8 billion for 2012.[255] As noted above, the Federal Government also directly subsidizes research activities. Direct government outlays for research have substantially exceeded the annual estimated value of the tax expenditure provided by either the research and experimentation tax credit or the expensing of research and development expenditures. For example, in fiscal 2008, the National Science Foundation gross outlays for research and related activities were $4.6 billion, the Department of Defense's budget for research, development, test and evaluation was $84.7 billion, the Department of Energy's science gross outlays were $3.9 billion, and the Department of Health and Human Services' budget for the National Institutes of health was $28.9 billion.[256] However, such direct government outlays generally are for directed research on projects selected by the government. The research credit provides a subsidy to any qualified project of an eligible

[255] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012* (JCS-2-08), October 31, 2008, p. 24.

[256] Office of Management and Budget, *Appendix*, *Budget of the United States Government, Fiscal Year 2010*, pp. 1141, 293, 295, 297, 413, and 469.

taxpayer with no application to a grant-making agency required. Projects are chosen based on the taxpayer's assessment of future profit potential.

Tables 8 and 9 present data for 2006 on those corporations that claimed the research tax credit by industry and asset size, respectively. Over 17,000 corporations (counting both C corporations and S corporations) claimed more than $7.6 billion of research tax credits in 2006.[257] Corporations whose primary activity is manufacturing account for just more than one-half of all corporations claiming a research tax credit. These manufacturers claimed more than 70 percent of all credits. Firms with assets of $50 million or more account for almost 17 percent of all corporations claiming a credit but represent more than 80 percent of the credits claimed. Nevertheless, as Table 9 documents, a large number of small firms are engaged in research and were able to claim the research tax credit. C corporations claimed almost $7.3 billion of these credits and, furthermore, nearly all of this $7.3 billion was the result of the firm's own research. Only $137 million in research credits flowed through to C corporations from ownership interests in partnerships and other pass-through entities.

For comparison, individuals claimed $388 million in research tax credits on their individual income tax returns in 2006. This $388 million includes credits that flowed through to individuals from pass-through entities such as partnerships and S corporations, as well those credits generated by sole proprietorships.

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[257] The $7.6 billion figure reported for 2006 is not directly comparable with the Joint Committee on Taxation staff's $4.8 billion tax expenditure estimate for 2006 (Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCS-1-05), January 12, 2005, p. 30). The tax expenditure estimate accounts for the present-law requirement that deductions for research expenditures be reduced by research credits claimed. Also, the $7.6 billion figure does not reflect the actual tax reduction achieved by taxpayers claiming research credits in 2006, as the actual tax reduction will depend upon whether the taxpayer had operating losses, was subject to the alternative minimum tax, and other aspects specific to each taxpayer's situation. In addition, at the time the Joint Committee on Taxation staff made its tax expenditure estimate, the law provided that the research credit would expire after December 31, 2005.

Table 8.–Percentage Distribution of Corporations Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 2006

Industry	Percent of Corporations Claiming Credit	Percent of Total R & E Credit
Manufacturing	50.7	71.6
Professional, Scientific, and Technical Services	23.4	10.0
Information	6.6	9.8
Wholesale Trade	8.6	3.5
Finance and Insurance	1.7	1.7
Holding Companies	2.8	1.1
Retail Trade	1.8	0.6
Health Care and Social Services	0.8	0.4
Utilities	0.3	0.4
Administrative and Support and Waste Management and Remediation Services	1.1	0.2
Mining	0.2	0.2
Transportation and Warehousing	0.5	0.1
Construction	0.4	0.1
Agriculture, Forestry, Fishing, and Hunting	0.5	(1)
Real Estate and Rental and Leasing	0.4	(1)
Arts, Entertainment, and Recreation	0.2	(1)
Educational Services	0.1	(1)
Other Services	(2)	(2)
Accommodation and Food Services	(2)	(2)
Wholesale and Retail Trade not Allocable	(2)	(2)
Not Allocable	(2)	(2)

[1] Less than 0.1 percent.
[2] Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Table 9.–Percentage Distribution of Corporations Claiming Research Tax Credit and of Credit Claimed by Corporation Size, 2006

Asset Size ($)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	2.1	0.9
1 to 99,999	5.0	(1)
100,000 to 249,999	1.6	(1)
250,000 to 499,999	4.5	0.1
500,000 to 999,999	9.1	0.3
1,000,000 to 9,999,999	39.9	5.4
10,000,000 to 49,999,999	20.9	12.4
50,000,000 +	16.9	80.7

Notes:

Totals may not add to 100 percent due to rounding.

(1) Less than 0.1 percent.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Flat versus incremental tax credits

For a tax credit to be effective in increasing a taxpayer's research expenditures, it is not necessary to provide that credit for all the taxpayer's research expenditures (i.e., a flat credit). By limiting the credit to expenditures above a base amount, incremental tax credits attempt to target the tax incentives to have the largest effect on taxpayer behavior.

Suppose, for example, a taxpayer is considering two potential research projects: Project A will generate cash flow with a present value of $105 and Project B will generate cash flow with a present value of $95. Suppose that the research cost of investing in each of these projects is $100. Without any tax incentives, the taxpayer will find it profitable to invest in Project A and will not invest in Project B.

Consider now the situation where a 10-percent flat credit applies to all research expenditures incurred. In the case of Project A, the credit effectively reduces the cost to $90. This increases profitability, but does not change behavior with respect to that project, since it would have been undertaken in any event. However, because the cost of Project B also is reduced to $90, this previously neglected project (with a present value of $95) would now be profitable. Thus, the tax credit would affect behavior only with respect to this marginal project.

Incremental credits do not attempt to reward projects that would have been undertaken in any event, but rather to target incentives to marginal projects. To the extent this is possible, incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures. In the example above, if an incremental credit were properly targeted, the government could spend the same $20 in credit dollars and induce the taxpayer to undertake a marginal project so long as its expected cash flow exceeded $80. Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken without a credit and to provide credits only to other projects. In practice, almost all incremental credit proposals rely on some measure of the taxpayer's previous experience as a proxy for a taxpayer's total qualified expenditures in the absence of a credit. This is referred to as the credit's base amount. Tax credits are provided only for amounts above this base amount.

Since a taxpayer's calculated base amount is only an approximation of what would have been spent in the absence of a credit, in practice, the credit may be less effective per dollar of revenue cost than it otherwise might be in increasing expenditures. If the calculated base amount is too low, the credit is awarded to projects that would have been undertaken even in the absence of a credit. If, on the other hand, the calculated base amount is too high, then there is no incentive for projects that actually are on the margin.

Nevertheless, the incentive effects of incremental credits per dollar of revenue loss can be many times larger than those of a flat credit. However, in comparing a flat credit to an incremental credit, there are other factors that also deserve consideration. A flat credit generally has lower administrative and compliance costs than does an incremental credit. Probably more important, however, is the potential misallocation of resources and unfair competition that could result as firms with qualified expenditures determined to be above their base amount receive credit dollars, while other firms with qualified expenditures determined to be below their base amount receive no credit.

Fixed base versus moving base credit

With the addition of the alternative simplified credit, taxpayers effectively have the choice of three different research credit structures for general research expenditures.[258] Each of the credit structures is an "incremental" credit. However, the base is determined differently in each case. The regular credit and the alternative incremental credit (which expired after 2008) are examples of "fixed base" credits. With a fixed base credit, the incremental amount of qualified research expenditures is determined without reference to the qualified research expenditures of a prior year. The alternative simplified credit is a "moving base" credit. With a moving base credit, the incremental amount of qualified research expenditures for a given year is determined by reference to one or more prior year's qualified research expenditures. The distinction can be important because, in general, an incremental tax credit with a base amount equal to a moving average of previous years' qualified expenditures is considered to have an effective rate of credit substantially below its statutory rate. On the other hand, an incremental tax credit with a base amount determined as a fixed base generally is considered to have an effective rate of credit equal to its statutory rate.

[258] A taxpayer election into one of these structures is permanent unless revoked by the Secretary. However, historically, permission to revoke an election has routinely been granted by the Secretary, effectively making the choice an annual election.

To see how a moving base creates a reduction in the effective rate of credit, consider the structure of the alternative simplified credit. The base of the credit is equal to 50 percent of the previous three years' average of qualified research expenditures. Assume a taxpayer has been claiming the alternative simplified credit and is considering increasing his qualified research expenditures this year. A $1 increase in qualified expenditures in the current year will earn the taxpayer 14 cents in credit in the current year but it will also increase the taxpayer's base amount by 16.7 cents (50 percent of $1 divided by three) in each of the next three years. If the taxpayer returns to his previous level of research funding over the subsequent three years, the taxpayer will receive two and one-third cents less in credit than he otherwise would have. Assuming a nominal discount rate of 10 percent, the present value of the one year of credit increased by 14 cents followed by three years of credits reduced by two and one-third cents is equal to 8.19 cents. That is, the effective credit rate on a $1 dollar increase in qualified expenditures is 8.19 percent.

An additional feature of the moving average base calculation of the alternative simplified credit is that it is not always an incremental credit. If the taxpayer never alters his or her research expenditures, the alternative simplified credit is the equivalent of a flat rate credit with an effective credit value equal to one half of the statutory credit rate. Assume a taxpayer spends $100 per year annually on qualified research expenses. This taxpayer will have an annual base amount of $50, with the result that the taxpayer will have $50 of credit eligible expenditures on which the taxpayer may claim $7 of tax credit (14 percent of $50). For this taxpayer, the 14-percent credit above the defined moving average base amount is equivalent to a seven-percent credit on the taxpayer's $100 of annual qualifying research expenditures.

The moving average base calculation of the alternative simplified credit also can permit taxpayers to claim a research credit while they decrease their research expenditures. Assume as before that the taxpayer has spent $100 annually on qualified research expenses, but decides to reduce research expenses in the next year to $75 and in the subsequent year to $50, after which the taxpayer plans to maintain research expenditures at $50 per year. In the year of the first reduction, the taxpayer would have $25 of qualifying expenditures (the taxpayer's prior three-year average base is $100) and could claim a credit of $3.50 (14 percent of the $75 current year expenditure less half of three year average base). In the subsequent four years, the taxpayer could claim a credit of $0.58, $1.75, $2.92, and $3.50.[259] Of course, it is also the case that a taxpayer may claim a research credit as he or she reduces research expenditures under a fixed base credit as long as the taxpayer's level of qualifying expenditures is greater than the fixed base.

Some have also observed that a moving base credit can create incentives for taxpayers to "cycle" or bunch their qualified research expenditures. For example, assume a taxpayer who is claiming the alternative simplified credit has had qualified research expenditures of $100 per year for the past three years and is planning on maintaining qualified research expenditures at $100 per year for the next three years. The taxpayer's base would be $50 for each of the next three years and the taxpayer could claim $7 of credit per year. If, however, the taxpayer could

[259] In the subsequent four years, 50 percent of the prior three years' expenditures equals $45.83, $37.50, $29.17, and $25.00. In each year, the taxpayer's expenditure of $50 exceeds 50 percent of the prior three years' expenditures.

bunch expenditures so that the taxpayer incurred only $50 of qualified research next year, followed by $150 in the second year and $100 in the third, the taxpayer could claim no credit next year but $15.17 in the second year and $7 dollars in the third. While the example demonstrates a benefit to cycling, as the majority of qualified research expenditures consist of salaries to scientists, engineers, and other skilled labor, the potential for cycling most likely would be limited in practice.

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of price elasticity, which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.[260] One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.[261]

While all published studies report that the research credit induced increases in research spending, early evidence generally indicated that the price elasticity for research is substantially less than one. For example, one early survey of the literature reached the following conclusion:

> In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of -0.2 and -0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.[262]

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[260] For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (i.e., the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity–such as research scientists and engineers–is in short supply.

[261] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken otherwise–so called marginal research expenditures–need be subject to the credit to have a positive incentive effect.

[262] Charles River Associates, "An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive" (final report prepared for the National Science Foundation), February, 1985, p. G-14. The negative coefficient in the text reflects that a <u>decrease</u> in price results in an <u>increase</u> in research expenditures. Often, such elasticities are reported without the negative coefficient, it being understood that there is an inverse relationship between changes in the "price" of research and changes in research expenditures.

In a 1983 study, the Treasury Department used an elasticity of 0.92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded

If it took time for taxpayers to learn about the credit and what sort of expenditures qualified, taxpayers may have only gradually adjusted their behavior. Such a learning curve might explain a modest measured behavioral effect. A more recent survey of the literature on the effect of the tax credit suggests a stronger behavioral response, although most analysts agree that there is substantial uncertainty in these estimates.

> [W]ork using US firm-level data all reaches the same conclusion: the tax price elasticity of total R&D spending during the 1980s is on the order of unity, maybe higher. … Thus there is little doubt about the story that the firm-level publicly reported R&D data tell: the R&D tax credit produces roughly a dollar-for-dollar increase in reported R&D spending on the margin.[263]

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that the estimate might be biased upward. See Department of the Treasury, "The Impact of Section 861-8 Regulation on Research and Development," p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerably smaller. For example, the General Accounting Office (now called the Government Accountability Office) summarizes: "These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of 0.2 and 0.5. . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit's impact." See *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD-89-114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: "While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3," in Edwin Mansfield, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191.

[263] Bronwyn Hall and John Van Reenen, "How Effective Are Fiscal Incentives for R&D? A Review of the Evidence," *Research Policy*, vol. 29, 2000, p. 462. This survey reports that more recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to appreciate fully the incentive structure of the revised credit. See Bronwyn H. Hall, "R&D Tax Policy During the 1980s: Success or Failure?" in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 7 (Cambridge: The MIT Press, 1993), pp. 1-35. Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, the estimated elasticities fell by half after including an additional 76 firms that had initially been excluded because they had been involved in merger activity. See James R. Hines, Jr., "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s" in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation* (Chicago: University of Chicago Press 1993). Also see M. Ishaq Nadiri and Theofanis P. Mamuneas, "R&D Tax Incentives and Manufacturing-Sector R&D Expenditures," in James M. Poterba, ed., *Borderline Case: International Tax Policy, Corporate Research and Development, and Investment* (Washington, D.C.: National Academy Press), 1997. While their study concludes that one dollar of research tax credit produces 95 cents of research, they note that time series empirical work is clouded by poor measures of the price deflators used to convert nominal research expenditures to real expenditures.

Other research suggests that many of the elasticity studies may overstate the efficiency of subsidies to research. Most R&D spending is for wages and the supply of qualified scientists is small, particularly in the short run. Subsidies may raise the wages of scientists, and hence research spending, without increasing actual research. See Austan Goolsbee, "Does Government R&D Policy Mainly Benefit Scientists and Engineers?" *American Economic Review*, vol. 88, May, 1998, pp. 298-302.

However, this survey notes that most of this evidence is not drawn directly from tax data. For example, effective marginal tax credit rates are inferred from publicly reported financial data and may not reflect limitations imposed by operating losses or the AMT. The study notes that because most studies rely on "reported research expenditures" that a "relabelling problem" may exist whereby a preferential tax treatment for an activity gives firms an incentive to classify expenditures as qualifying expenditures. If this occurs, reported expenditures increase in response to the tax incentive by more than the underlying real economic activity. Thus, reported estimates may overestimate the true response of research spending to the tax credit.[264]

Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

Other policy issues related to the research and experimentation credit

Perhaps the greatest criticism of the research and experimentation tax credit among taxpayers regards its temporary nature. Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is periodically renewed.

An incremental credit does not provide an incentive for all firms undertaking qualified research expenditures. Many firms have current-year qualified expenditures below the base amount. These firms receive no tax credit and have an effective rate of credit of zero. Although there is no revenue cost associated with firms with qualified expenditures below the base amount, there may be a distortion in the allocation of resources as a result of these uneven incentives.

If a firm has no current tax liability, or if the firm is subject to the AMT or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its present value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.[265]

Except for energy research, firms with research expenditures substantially in excess of their base amount are subject to the 50-percent base amount limitation. In general, although these firms received the largest amount of credit when measured as a percentage of their total qualified research expenses, their marginal effective rate of credit was exactly one half of the

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[264] Hall and Van Reenen, "How Effective Are Fiscal Incentives for R&D? A Review of the Evidence," p. 463.

[265] As with any tax credit that is carried forward, its full incentive effect could be restored, absent other limitations, by allowing the credit to accumulate interest that is paid by the Treasury to the taxpayer when the credit ultimately is utilized.

statutory credit rate of 20 percent (i.e., firms subject to the base limitation effectively are governed by a 10-percent credit rate).

Although the statutory rate of the research credit is 20 percent, it is likely that the average effective marginal rate may be substantially below 20 percent. Reasonable assumptions about the frequency that firms are subject to various limitations discussed above yield estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate, i.e., between 12 and 15 percent.[266]

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will drift from the firm's actual current qualified research expenditures. Therefore, if the research credit were made permanent, increasingly over time there would be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms would receive no credit and have no reasonable prospect of ever receiving a credit, while other firms would receive large credits (despite the 50-percent base amount limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average effective marginal rate of credit would decline while the revenue cost to the Federal government increased.

As explained above, because costly scientific and technological advances made by one firm may often be cheaply copied by its competitors, research is one of the areas where there is a consensus among economists that government intervention in the marketplace, such as the subsidy of the research tax credit, can improve overall economic efficiency. This rationale suggests that the problem of a socially inadequate amount of research is not more likely in some industries than in other industries, but rather it is an economy-wide problem. The basic economic rationale argues that a subsidy to reduce the cost of research should be equally applied across all sectors. As described above, the Energy Policy Act of 2005 provided that energy-related research receive a greater tax subsidy than other research. Some argue that it makes the tax subsidy to research inefficient by biasing the choice of research projects. They argue that an energy-related research project could be funded by the taxpayer in lieu of some other project that would offer a higher rate of return absent the more favorable tax credit for the energy-related project. Proponents of the differential treatment for energy-related research argue that broader policy concerns such as promoting energy independence justify creating a bias in favor of energy related research.

Complexity and the research tax credit

Administrative and compliance burdens result from the research tax credit. The Government Accountability Office ("GAO") has testified that the research tax credit is difficult for the IRS to administer. According to the GAO, the IRS reports that it is required to make difficult technical judgments in audits concerning whether research is directed to produce truly innovative products or processes. While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise

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[266] For a more complete discussion of this point, see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92), January 27, 1992, pp. 65-66.

and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.[267] An executive in a large technology company has identified the research credit as one of the most significant areas of complexity for his firm. He summarizes the problem as follows.

> Tax incentives such as the R&D tax credit … typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company's operational units. … [I]s what the company calls "research and development" the same as the "qualified research" eligible for the R&D tax credit under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.[268]

In addition to compliance challenges, with the addition of the alternative simplified credit, taxpayers now have three research credit structures to choose from, not including the energy research credit and the university basic research credit. The presence of multiple research credit options creates increased complexity by requiring taxpayers to make multiple calculations to determine which credit structure will result in the most favorable tax treatment.

Prior Action

The President's budget proposals for fiscal years 2003 through 2006 contained an identical proposal. The President's budget proposal for fiscal year 2007 contained a similar proposal, but did not extend or make permanent the energy research credit. The President's budget proposals for fiscal years 2008 through 2010 contained an identical proposal.

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[267] Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, "Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight," Committee on Finance, United States Senate, April 3, 1995.

[268] David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company," *National Tax Journal*, vol. 50, September 1997, pp. 487-493.

C. Remove Cell Phones from Listed Property

Present Law

Employer deduction

Property, including cellular telephones and similar telecommunications equipment (hereinafter collectively "cell phones"), used in carrying on a trade or business is subject to the general rules for deducting ordinary and necessary expenses under section 162. Under these rules, a taxpayer may properly claim depreciation deductions under the applicable cost recovery rules for only the portion of the cost of the property that is attributable to use in a trade or business.[269] Similarly, the business portion of monthly telecommunication service is generally deductible, subject to capitalization rules, as an ordinary and necessary expense of carrying on a trade or business.

In the case of certain listed property, special rules apply. Listed property generally is defined as (1) any passenger automobile; (2) any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment; (5) any cellular telephone (or other similar telecommunications equipment);[270] and (6) any other property of a type specified in Treasury regulations.[271]

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.[272] A taxpayer must substantiate the elements of each expenditure or use of listed property, including: (1) the amount (e.g., cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (e.g., mileage for automobiles), and the total use of the property for the taxable period; (2) the date of the expenditure or use; and (3) the business purposes for the expenditure or use.[273] The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.[274]

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[269] Sec. 212 allows deductions for ordinary and necessary expenses paid or incurred for the production or collection of income.

[270] Cellular telephones (or other similar telecommunications equipment) were added as listed property as part of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7643 (1989).

[271] Sec. 280F(d)(4)(A).

[272] Sec. 274(d)(4).

[273] Treas. Reg. sec. 1.274-5T(b)(6).

[274] Treas. Reg. sec. 1.274-5T(c)(2)(ii)(C).

With respect to the business use of listed property made available by an employer for use by an employee, the employer must substantiate that all or a portion of the use of the listed property is by employees in the employer's trade or business.[275] If any employee used the listed property for personal use, the employer must substantiate that it included an appropriate amount in the employee's income.[276] An employer generally may rely on adequate records maintained and retained by the employee or on the employee's own statement if it is corroborated by other sufficient evidence, unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate.[277]

Taxation of employee

Gross income includes all income unless a specific exclusion applies.[278] An exclusion from gross income is provided in the case of certain working condition fringe benefits.[279] A working condition fringe benefit is any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.[280] An employee may not exclude from gross income as a working condition fringe benefit, the value of listed property provided by an employer to the employee, unless the employee substantiates for the period of availability the amount of the exclusion in accordance with the substantiation requirements discussed above.[281]

Cost recovery

A taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the taxpayer's depreciation deduction would be maximized.

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[275] Treas. Reg. sec. 1.274-5T(e)(2)((i)(A).

[276] *Ibid*.

[277] Treas. Reg. sec. 1.274-5T(e)(2)(ii). In Notice 2009-46, 2009-23 I.R.B. 1068, the Service requested comments regarding several proposals to simplify the procedures for employers to substantiate an employee's business use of certain employer-provide telecommunications equipment (including cellular telephones).

[278] Sec. 61.

[279] Sec. 132(a)(3).

[280] Sec. 132(d).

[281] Treas. Reg. sec. 1.132-5(a)(1)(ii); Temp. Reg. sec. 1.274-5T(e)(1).

In the case of certain listed property, special depreciation rules apply. First, if for the taxable year that the property is placed in service the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.[282] The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.[283] Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.[284]

Description of Proposal

The proposal removes cell phones from the definition of listed property and excludes from an employee's income the fair market value of the personal use of a cell phone provided by the employer primarily for business purposes. Under the proposal, the heightened substantiation requirements and special depreciation rules that apply to listed property do not apply to cell phones. Additionally, the proposal eliminates the need for documentation by the employee of personal use of an employer-provided cell phone, where such phone is used primarily for business by the employee.

Effective date.–The proposal is effective for taxable years ending after date of enactment.

Analysis

Special rules for "listed property," originally enacted in the Tax Reform Act of 1984, limited depreciation and other tax benefits for business property that was likely to be used for personal purposes.[285] Listed property initially was limited to automobiles and computers in TEFRA, but was expanded to include cell phones in the Revenue Reconciliation Act of 1989.[286] At that time, the cost of cell phones and the cost of cell phone services were expensive. One

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[282] Sec. 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (i.e., included in gross income) for such taxable year and subsequent depreciation allowances are determined under the alternative depreciation system.

[283] Sec. 168(g).

[284] Sec. 280F(d)(3).

[285] Pub. L. No. 98-369.

[286] Pub. L. No. 101-239.

wireless industry survey estimated the number of wireless subscribers at approximately 2.7 million in June 1989 and at approximately 276.6 million in June 2009.[287]

As cell phones have become ubiquitous and calling plans have changed from per-minute to unlimited calling plans for a fixed fee (often with plans providing free nights/weekends or free calls between certain parties), the listed property designation of cell phones has been questioned. Commentators argue that the documentation requirements for listed property are no longer appropriate for cell phones as a result of the price declines, changes in calling plans, and the fact that cell phones are used on a daily basis by businesses to promote productivity and efficiency.[288] These commentators note that cell phone usage is the expected "norm" and the prevalent use of cell phones has made them "the equivalent of a landline phone, for which detailed recordkeeping has never been required."[289]

The IRS has also recognized the growing concern regarding compliance with the listed property substantiation requirements for cell phones. In June 2009, the IRS issued Notice 2009-46 requesting comments regarding various proposals to simplify the procedures under which employers substantiate an employee's business use of employer-provided cell phones. Commentators have commended the IRS for its simplification efforts, but noted that a legislative change would be the best simplification.[290]

Prior Action

None.

[287] CTIA-The Wireless Association Semi-Annual Wireless Industry Survey 2009, available at http://files.ctia.org/pdf/CTIA_Survey_Midyear_2009_Graphics.pdf

[288] Written Testimony of Scott Mackey, Kimbell Sherman Ellis, LLP, before the Small Business Committee U.S. House of Representatives, April 10, 2008.

[289] Written Statement of the American Institute of Certified Public Accountants-Tax Division submitted to the Committee on Small Business U.S. House of Representatives, IRS Oversight and Tax Compliance Hearing, April 1, 2009.

[290] AICPA Comments on Notice 2009-46 dated September 18, 2009, available at http://services.taxanalysts.com/taxbase/eps_pdf2009.nsf/DocNoLookup/21018/$FILE/2009-21018-1.pdf

VI. OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS

A. Reform Treatment of Financial Institutions and Products

1. Impose a financial crisis responsibility fee

Present Law

Corporations generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[291] generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Corporations that make a valid election pursuant to section 1362 of Subchapter S of Chapter 1 of the Code, referred to as S corporations, are taxed differently. In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns. To prevent double taxation of these items upon a subsequent disposition of S corporation stock, each shareholder's basis in such stock is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

To qualify for S corporation status, a corporation must be a small business corporation as defined in section 1361(b)(1) and not be an ineligible corporation as defined in section 1361(b)(2). A corporation qualifies as a small business corporation if it has 100 or fewer shareholders, has only individuals or certain trusts and estates as shareholders, has no nonresident aliens as shareholders, and has only one class of stock. Ineligible corporations include any financial institution using the reserve method of accounting for bad debts (discussed below) and any insurance company subject to Subchapter L of the Code.

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[291] Corporations subject to tax are commonly referred to as C corporations after Subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (Real Estate Investment Trusts) or in stock and securities (Regulated Investment Companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to Subchapter C.

Banks, Thrifts, and Credit Unions

In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with certain specified exceptions. There is no sector-specific Federal income tax currently applied to financial institutions, and there are currently no corporate taxes assessed on the balance sheet liabilities of an entity.

Certain special rules and exceptions that are applicable to determining the Federal income tax liability of banks and thrifts, certain other financial institutions, insurance companies, and broker dealers are discussed below.

C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[292] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[293] Prior to 1951, thrifts were exempt from Federal taxation. In 1951, mutual savings banks and savings and loan associations lost their tax exemption because they were viewed as being "in active competition with commercial banks and life insurance companies for the public savings."[294]

S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.

Special bad debt loss rules for small banks

Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. For taxable years beginning before 1987, section 166(c) allowed taxpayers to deduct annual reasonable additions to a reserve established for bad debts (in lieu of deducting specific debts as worthless in the year in which the bank determined the debt was worthless). The reserve method of accounting for bad debts was repealed in 1986[295] for most

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[292] Sec. 581.

[293] See Treas. Reg. sec. 1.581-1 ("in order to be a bank as defined in section 581, an institution must be a corporation for Federal tax purposes") and Treas. Reg. sec. 1.581-(2)(a) ("While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank…there are certain exceptions and special rules [for such institutions]").

[294] S. Rep. No. 82-781, Revenue Act of 1951, at 25.

[295] Tax Reform Act of 1986, Pub. L. No. 99-514.

taxpayers, but is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if for the taxable year (or for any preceding taxable year after 1986) the average adjusted basis of all its assets (or the assets of the controlled group of which it was a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that looks to the ratio of (1) total bad debts sustained during a taxable year to (2) the total bad debts over the five preceding taxable years. A large bank is allowed a deduction for specific bad debts charged off during a taxable year.

Prior to 1996, thrifts (mutual savings banks, domestic savings and loan associations, and cooperative banks) had separate bad debt reserve rules under section 593. The special rules for thrifts were repealed for tax years beginning on or after January 1, 1996.

Credit unions

Credit unions are exempt from Federal income taxation.[296] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater utilization of credit unions.[297] While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[298]

Gains and losses with respect to securities held by financial institutions

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain of a corporation is currently taxed at a rate not to exceed 35 percent, which is also the maximum corporate income tax rate. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

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[296] Sec. 501(c)(14). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, available at http://www.ustreas.gov/press/releases/report3070.htm.

[297] The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple-common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

[298] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, p. 2, available at http://www.ustreas.gov/press/releases/report3070.htm.

Capital losses generally are deductible in full against capital gains. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges. Thus, in taxable years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income. However, in general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year.

In the case of an S corporation, net capital losses flow through to the corporation's shareholders and could be considered losses attributable to a banking business in such shareholders' hands. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the assets, liabilities, relative liquidity, and diversification objectives. As a result, for Federal income tax purposes, gains and losses on a bank's investment portfolio would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year attributable to that banking business. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; (5) certain U.S. publications; (6) certain commodity derivative financial instruments; (7) hedging transactions; and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Under section 582(c)(1), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in section 582(c)(2) is not considered a sale or exchange of a capital asset. Thus, generally, as a manufacturer receives ordinary income treatment on sale of its inventory, so does a financial institution on the sale or exchange of its loans under section 582. A financial institution described in section 582(c)(2) includes: (1) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation); (2) any financial institution referred to in section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under

Federal or State law; (3) any small business investment company operating under the Small Business Investment Act of 1958; and (4) any business development corporation, defined as a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or State in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Stock (including preferred stock) is not considered indebtedness for tax purposes and therefore is not treated as an asset entitled to ordinary gain or loss treatment under section 582.[299] However, under section 301 of Division A of the Emergency Economic Stabilization Act of 2008,[300] gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in section 582(c)(2) or a depository institution holding company, as defined in the Federal Deposit Insurance Act.[301] Applicable preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (1) held by the applicable financial institution on September 6, 2008, or (2) sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[302]

Insurance companies

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. An insurance company is subject to tax as a life insurance company if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves.[303] All other taxable insurance companies are treated as property and casualty insurance companies for Federal income tax purposes. Insurance companies are subject to tax at regular corporate income tax rates.

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[299] Under section 306 of the Code, the sale of certain preferred stock can produce ordinary income to any taxpayer (without regard to section 582).

[300] Pub. L. No. 110-343.

[301] 12 U.S.C. 1813(w)(1).

[302] On September 7, 2008, the Federal Housing Finance Agency ("FHFA") placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9 percent of the common stock of such companies.

[303] Sec. 816.

A life insurance company is subject to tax on its life insurance company taxable income.[304] Life insurance company taxable income is the sum of premiums and other consideration on insurance and annuity contracts, decreases in certain reserves, and other amounts includible in gross income, reduced by allowable deductions for all claims and benefits accrued and all losses incurred during the taxable year, increases in certain reserves, policyholder dividends, dividends received, operations losses, certain reinsurance payments, and other deductions allowable for purposes of computing taxable income.[305]

The taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[306] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

Certain special rules apply to both life insurance and property and casualty companies. These rules relate to foreign tax credits, foreign companies carrying on insurance business within the United States, annual accounting period, special loss carryovers, certain reinsurance agreements, discounted unpaid losses, special estimated tax payments, and capitalization of certain policy acquisition expenses.[307]

Broker-dealers

For Federal income tax purposes, a person is a securities dealer if such person is regularly engaged in the purchase and resale of securities to customers.[308] The determination of dealer status is made based on all facts and circumstances. The courts and the IRS have considered the following factors in evaluating dealer status: (1) being licensed as a dealer;[309] (2) holding oneself out to the public as a dealer;[310] (3) selling inventoried securities to customers;[311] (4) the frequency, extent, and regularity of securities transactions;[312] (5) profiting from commissions as

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[304] Sec. 801.

[305] Secs. 801-818.

[306] Sec. 832.

[307] Secs. 841-848.

[308] Treas. Reg. sec. 1.471-5 (as amended in 1993). In *Bielfeldt v. Commissioner*, 231 F.3d 1035 (7th Cir. 2000), the Seventh Circuit described the difference between a trader and a dealer noting that "the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely fluctuations in the market value of the securities or other assets that he transacts in."

[309] *Polachek v. Commissioner,* 22 T.C. 858, 859 (1954).

[310] *Verito v. Commissioner,* 43 T.C. 429, 441-442 (1965), *acq.* 1965-2 C.B. 7.

[311] *United States v. Chinook Investment Co.,* 136 F.2d 984 (9th Cir. 1943).

opposed to appreciation in the value of securities;[313] and (6) ownership of a securities exchange membership.[314]

Securities dealers must account for their securities inventory using the mark-to-market accounting method.[315] In general, under that method, securities held by a dealer in its inventory are marked to fair market value at the close of the taxable year, with any resulting difference between value and basis included as ordinary income or loss in computing taxable income for such year. For this purpose a security is defined as any share of stock in a corporation, partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, interest rate, currency, or equity notional principal contract, and evidence of an interest in, or a derivative financial instrument in any of the foregoing, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.[316] Additionally, a security includes a position that is not one of the foregoing, but is a hedge with respect to such security, and is clearly identified in the dealer's records as a security before the close of the day on which it was acquired.[317]

Special rules apply to gains and losses of a securities dealer with respect to "section 1256 contracts."[318] Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss.[319] Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or

[312] *Purvis v. Commissioner,* 530 F.2d 1332, 1334 (9th Cir. 1976).

[313] *Kemon v. Commissioner*, 16 T.C. 1026, 1033 (1951).

[314] *Securities Allied Corp. v. Commissioner*, 95 F.2d 284, 286 (2d Cir. 1938), *aff'g* 36 B.T.A 168 (1937), *cert denied*, 305 U.S. 617 (1938).

[315] Sec. 475. Section 475(c)(1) defines a securities dealer for purposes of section 475 as "a taxpayer who-(A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or (B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business."

[316] Sec. 475(c)(2). The definition of securities under section 475 excludes section 1256 contracts, which include futures contracts and certain exchange-traded options.

[317] Sec. 475(c)(2)(F).

[318] Section 1256(b) provides that a "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract; (3) nonequity option, (4) dealer equity option; and (5) dealer securities futures contract.

[319] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[320]

A securities dealer may also hold securities for investment rather than as inventory (such securities are not subject to mark-to-market accounting, and any gains or losses with respect thereto treated as capital rather than ordinary).[321] Additionally, a dealer is not subject to mark-to-market accounting for debt securities originated or entered into in the ordinary course of its trade or business that are not held for sale.[322] For either of these exceptions to apply, the dealer must clearly identify that the security is either held for investment or not held for sale by the close of the day the security is acquired and the security may not at any time thereafter be held primarily for sale to customers.[323]

Description of Proposal

The proposal imposes an annual financial crisis responsibility fee based on certain liabilities of banks, thrifts, bank and thrift holding companies, brokers and securities dealers, as well as on U.S. companies owning or controlling such entities as of January 14, 2010. The proposed rate has not been determined, but is expected to be approximately 0.15 percent of an applicable financial firm's covered liabilities. Covered liabilities are defined as total balance sheet assets minus capital, deposits subject to assessments by the Federal Deposit Insurance Corporation (the "FDIC") (in the case of banks), certain insurance policy-related liabilities (in the case of insurance companies) and other (unspecified) exceptions.[324] The fee is assessed on the worldwide consolidated liabilities of firms headquartered in the United States, and the consolidated liabilities of U.S. subsidiaries of non-U.S. financial firms. The fee only applies to firms with consolidated assets in excess of $50 billion. Firms with consolidated assets of less than $50 billion would not be subject to the fee for the period when their assets are below the threshold.

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[320] Sec. 1256(c)(1). Additionally, section 1212(c) provides that a taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.

[321] Secs. 1236 and 475(b)(1).

[322] Sec. 475(b)(1).

[323] Secs. 1236(a) and (d)(1). See also, section 475(b)(2).

[324] On May 4, 2010, Secretary of Treasury Timothy Geithner testified before the Senate Finance Committee regarding the Administration's proposed fee on financial institutions. Secretary Geithner's testimony suggested a tax levied on the risk weighted assets of covered institutions (rather than total balance sheet liabilities), minus capital, insured deposits and certain policy reserves. The following discussion is limited to the proposal as outlined in the Administration's Fiscal Year 2011 Budget, and the Administration's initial public announcement regarding the fee available at http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn. For a discussion of risk weighted assets in the context of the proposed financial crisis responsibility fee, see Joint Committee on Taxation, *Background and Issues Related to the Administration's Proposed Tax on Financial Institutions* (JCX-26-10), April 16, 2010. For a discussion of risk weighting schemes more generally, see Congressional Research Service, *The Basel Accords: The Implementation of II and the Modification of I (RL 33278)*, February 21, 2006, by Walter W. Eubanks, available at http://www.crs.gov/ReportPDF/RL33278.pdf.

The fee is reported on a firm's Federal income tax return. The fee is payable through payments on the same schedule as estimated income tax payments.

Effective date.−The proposal is effective as of July 1, 2010. Thus, calendar year taxpayers would pay the fee with respect to two quarters of the year when filing their 2010 returns.

Analysis

Significant details of the Administration's proposal are unclear, including both the firms subject to the tax and the intended tax base. The uncertainty makes evaluating the technical details of the proposal difficult, but may also be used to highlight issues in need of further consideration.

Covered institutions

The universe of covered institutions is not entirely clear from the initial proposal. For example, the fact sheet released in conjunction with the Administration's initial announcement of the fee explains that covered institutions "would include firms that were insured depository institutions, bank holding companies, thrift holding companies, insurance or other companies that owned insured depository institutions, or securities broker-dealers as of January 14, 2010, or that become one of these types of firms…"[325] This sentence is perhaps best read to mean that only an insurance company that owns an insured depository subsidiary (or broker-dealer) qualifies as a covered institution, but it can also be read to mean any insurance company is covered. The Administration's description further suggests that an insurance company is a covered institution only if it owns a bank, broker or securities dealer, providing that "the fee would be applied to banks, thrifts, bank and thrift holding companies, brokers and securities dealers [and] U.S. companies owning or controlling these types of entities…"[326]

Some may argue it is arbitrary to apply the fee to an insurance company that happens to have a small bank subsidiary, but to exempt an otherwise similarly situated insurance company that does not have a bank subsidiary, or to exempt an insurance company with less than $50 billion in assets but with a larger banking subsidiary than an insurance company with assets exceeding $50 billion. In response, others may argue that the tax is intended to apply to the largest, most systemically significant entities that were eligible to receive TARP benefits, whether or not they actually received TARP funds. Thus, the argument goes, insurance companies that owned a thrift, or acquired one in order to qualify for TARP benefits, are properly subject to the fee. However, it is also possible that defining a covered institution as any company owning any of these other entities could subject unintended entities to the fee. For example, unless otherwise exempted, mutual fund groups owning captive securities broker-dealers to service fund trading requirements would be subject to the fee.

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[325] Available at http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf.

[326] See, U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, p. 29.

Another ambiguity is presented by the $50 billion consolidated asset threshold. The fee applies to firms with more than $50 billion in consolidated assets and would not apply to otherwise eligible entities for the period when their assets are below this threshold. Some may argue that the $50 billion in consolidated assets threshold establishes an arbitrary line. Opponents may note that a bright line threshold can alter the behavior of taxpayers operating near the threshold. In addition, it is not clear what is intended by "consolidated." The meaning of, and requirements for, consolidation differs in the financial reporting and U.S. Federal income tax contexts. Further, it is uncertain whether the proposal intends a more comprehensive definition which might, for instance, look through to the assets and liabilities of entities owned or controlled by the affected entities but which are not typically consolidated Federal income tax purposes, but the assets of which might be included for financial statement purposes.

Tax base

Under the Administration's proposal, the fee applies to the "worldwide consolidated liabilities" of covered firms, but as described above, the meaning of "consolidated" is not clear and could vary significantly in scope. Moreover, the proposal contemplates exceptions to the tax, including FDIC-assessed deposits and "certain policy-related liabilities." It is not clear from the proposal which liabilities would be subject to the fee, which would be excluded, or the method for determining inclusion or exclusion.

One rationale for the fee is that it would provide a deterrent against excessive, and potentially risky, leverage for the largest firms. Risk in this context has various meanings.[327] Financial institutions face systemic risk commonly described as risk an institution faces as a market participant against which it cannot diversify. Financial institutions may also contribute to systemic risk, that is, risk that the linkages between institutions in the financial system might affect the economy as a whole. Various risks may also be identified on both sides of a financial institution's balance sheet. On the asset side, each originated or held loan involves credit risk (whether the borrower pays) and interest rate risk (generally, when interest rates increase and the value of the loan drops, or rates decrease and borrowers accelerate their repayments).

With respect to the liabilities side of the balance sheet, liquidity risk includes the sudden withdrawal or unavailability of funds. A financial institution commonly faces varying degrees of durational risk, that is, a mismatch in the terms and timing of cash flows of its assets and its obligations. Banks typically raise money for long-term loans, such as 30-year residential mortgages, by borrowing short-term from depositors who can withdraw their money at any time. Thus, a sudden withdrawal of capital (e.g., a run on a bank) could result in an insolvent bank regardless of the quality of its assets if such assets cannot be liquidated quickly enough. A nondepository institution that relies on other forms of short-term capital with long-term assets faces a similar risk. Managing these risks is the principal business of financial intermediaries, and for which investors in these institutions are compensated. Bank regulatory capital requirements are generally intended to address these solvency risks.

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[327] See, e.g., Congressional Research Service, *Who Regulates Whom? An Overview of U.S. Financial Supervision (R40249)*, December 14, 2009, by M. Jickling and E. Murphy, available at http://www.crs.gov/ReportPDF/R40249.pdf.

It could be argued that the Administration's proposal contributes to the stability of the financial system to the extent it provides a disincentive to raise funds using certain types of risky leverage. Others might counter that the proposal, in effect, imposes a fee on all leverage other than FDIC assessed deposits (or certain policy reserve related assets) which may or may not be particularly risky or even possible to avoid. For example, general trade liabilities such as accounts payable would be subject to the fee. The fee would also be applied without regard to duration of the liability. For certain nonbank entities during the recent financial crisis, short-term wholesale liabilities drove a liquidity crunch when the short-term lenders lost confidence in such institutions' credit worthiness.[328] However, the fee would apply to such potentially risky short-term debt and to long-term investment grade corporate debt issuances equally.

On the other hand, some might argue the proposal has little effect on risk insofar as it taxes all liabilities other than a narrowly identified group, and does nothing to address risk taken on the asset side of the balance sheet. Exceedingly risky positions can be financed with liabilities that the proposal would exclude from the tax base. Banking regulations attempt to address the risks to a bank's creditors posed by holding risky assets by requiring institutions with riskier assets to hold more of a particular type of regulatory capital referred to as "Tier 1 capital." However, to the extent banks only hold capital sufficient to comply with regulations, exempting Tier 1 capital from the tax base (as in the Administration's proposal) could have the effect of imposing a lower tax burden on riskier institutions. This may result because a bank holding riskier assets must hold more Tier 1 capital than an otherwise similarly situated bank with less risky assets. Therefore, removing Tier 1 capital from the tax base effectively imposes a greater tax liability on a bank with less risky assets.

Some might contend that a tax measured as a fixed percentage of assets or liabilities may actually encourage institutions to undertake riskier investments in pursuit of higher returns to offset the cost of the tax. However, one can counter that those higher risk and higher return investments were also available in the absence of the tax. Having rejected a higher risk/higher return portfolio when its costs were lower, it is not clear why a profit maximizing firm would choose such a portfolio in the face of the tax. On the other hand, if the tax increased the likelihood that the firm would become insolvent given its current investment choices, a firm may be willing to increase the risk of its portfolio in pursuit of higher returns to stave off bankruptcy.

Prior Action

No prior action.

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[328] See, e.g., Congressional Research Service, *Bear Stearns: Crisis and "Rescue" for a Major Provider of Mortgage-Related Products (Report RL34420)*, April 9, 2008 by Gary Shorter, available at http://apps.crs.gov/products/rl/pdf/RL34420.pdf.

2. Require accrual of the time-value element on forward sale of corporate stock

Present Law

A corporation generally recognizes no gain or loss on the receipt of money or other property in exchange for its own stock (including treasury stock).[329] Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued. In addition, no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

In general, a forward contract means a contract to deliver at a set future date (the "settlement date") a substantially fixed amount of property (such as stock) for a substantially fixed price. Gains or losses from forward contracts generally are not taxed until the forward contract is closed. A corporation does not recognize gain or loss with respect to a forward contract for the sale of its own stock. A corporation does, however, recognize interest income upon the current sale of its stock for a deferred payment.

With respect to certain "conversion transactions" (transactions generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction), gain recognized that would otherwise be treated as capital gain may be recharacterized as ordinary income.[330]

Description of Proposal

The proposal requires a corporation that enters into a forward contract for the sale of its own stock to treat a portion of the payment received with respect to the forward contract as a payment of interest.

Effective date.−The proposal is effective for forward contracts entered into on or after December 31, 2011.

Analysis

Under a traditional forward contract, the purchase price generally is determined by reference to the value of the underlying property on the contract date and is adjusted (1) upward to reflect a time value of money component to the seller for the deferred payment (i.e., for holding the property) from the contract date until the settlement date and (2) downward to reflect the current yield on the property that will remain with the seller until the settlement date.

Strategies have been developed whereby a corporation can obtain favorable tax results through entering into a forward sale of its own stock, which results could not be achieved if the

[329] Sec. 1032.

[330] Sec. 1258.

corporation merely sold its stock for a deferred payment. One such strategy that might be used to increase a corporation's interest deductions could involve a corporation borrowing funds (producing an interest deduction) to repurchase its own stock, which it immediately sells in a forward contract at a price equal to the principal and interest on the debt for settlement on the date that the debt matures. Taxpayers may be taking the position that the interest on the debt is deductible, while the gain and loss from the forward contract (including any interest component) is not taxable to the corporation. Although the leveraged purchase illustrates the problem, the borrowing is not necessary to achieve the tax benefits. A corporation could simply use excess cash (which otherwise would be earning a taxable return) to purchase its own outstanding stock and contemporaneously enter into a forward contract to sell the same amount of its stock at a price that reflects a return that is substantially based on the time value of money.[331] In either case, the corporation arguably has achieved a tax-free return on investment.

Advocates of the proposal argue that there is little substantive difference between a corporation's current sale of its own stock for deferred payment (upon which the corporate issuer would accrue interest[332]) and the corporation's forward sale of the same stock. The primary difference between the two transactions is the timing of the stock issuance. In a current sale, the stock is issued at the inception of the transaction, while in a forward sale, the stock is issued on the settlement date. In both cases, a portion of the deferred payment economically compensates the corporation for the time-value element of the deferred payment. Proponents of the proposal argue that these two transactions should be treated the same. Additionally, some would argue that the proposal is a logical extension of the conversion rules of section 1258 (discussed below) which treat as ordinary income the time-value component of the return from certain conversion transactions.

Opponents of the proposal argue that there is, in many cases, a substantive difference between a corporation's forward sale of its stock and a current sale for a deferred payment. Under a forward sale, the stock is not outstanding until it is issued on the settlement date. The purchaser does not actually own stock that it can transfer free of its obligation to make payment under the forward contract. The purchaser has no current dividend rights, voting rights or rights in liquidation. The forward price may reflect expected dividends on the underlying stock, but that price is generally established in advance and actual dividends may vary from expected dividends. The purchaser of stock for a deferred payment, on the other hand, actually owns the stock and the attendant rights thereto. Therefore, the current sale of stock for deferred payment and the forward sale of stock for future delivery may not be equivalent transactions, but the proposal would treat them the same. Conversely, the proposal would treat differently a forward

331 For example, suppose the prevailing interest rate is five percent. A corporation that has $1,000 cash can lend the money to a third party for a year and earn a taxable return $50. If the corporation instead used the money to purchase $1,000 of its own stock and then immediately entered into a forward contract to sell the same amount of stock one year later for $1,050 (the forward price assuming a five percent discount rate and no dividend on the stock), it could earn a $50 tax-free return, assuming the gain on the forward sale is not recognized under section 1032.

332 See, e.g., sec. 1272 (requiring current inclusion in income of original issue discount).

sale of stock and an issuance in the future of stock for the same price on the same date as the settlement date, which in many respects may be viewed as similar transactions.

In addition, any forward sale by its very nature has a time-value component: that feature is not unique to a corporate issuer of its own stock. The time-value component should compensate the holder for its carrying costs with respect to the property. One could argue that if it is appropriate to impute interest on a forward contract, it should be done for all forward contracts and not just forward contracts involving a corporation's own stock. In other words, as a policy matter it may be inappropriate to address forward sales of a corporation's own stock without addressing the broader question of taxation of the time-value component of forward contracts in general.

The conversion rules of section 1258 provide the closest analog under present law to the proposal. There are, however, several important distinctions between section 1258 and the proposal. Unlike the proposal, the conversion rules (1) do not affect the timing of recognition of the ordinary income and (2) apply only to forward contracts that are part of a conversion transaction. In addition, some also might argue that the policy rationale underlying the conversion rules is not present with respect to the issuance of corporate stock because there is no conversion of ordinary income to capital gain. For example, assume a taxpayer buys gold today for $100 and immediately enters into a forward contract to sell that gold in the future for $110 ($10 of which represents the time value of money). Upon closing of the forward sale, the taxpayer (and its shareholders if it is a corporation) would recognize an economic gain of $10. Absent the conversion rules, the $10 gain on that transaction may be treated as capital gain notwithstanding that substantially all of the taxpayer's return is with respect to the time value of money. The taxpayer is in the economic position of a lender with an expectation of a return from the transaction that is in the nature of interest and with no significant risks other than those typical of a lender. That arguably is not the case (at least with respect to the economic position of the existing shareholders) with respect to a corporation that enters into a forward sale of its own stock (or certainly not all forward sales of a corporation's own stock). A corporation's ownership of its own stock arguably has no economic significance to the corporation or its shareholders. The purchase or issuance by a corporation of its own stock at fair market value does not affect the value of the shareholders' interests in the corporation. The economic gain or loss, if any, to the existing shareholders of the corporation on the forward sale of its stock would depend on the fair market value of the corporation's stock on the settlement date. If the fair market value of the corporation's stock on the settlement date equals the contract price under the forward sale, then there is no economic gain or loss to the corporation or its shareholders. On the other hand, if the forward price does not equal the fair market value, there could be situations in which the corporation suffers an economic loss (because, for example, the value of the stock is greater than the forward price). Even in situations in which there is an economic loss, however, the proposal would tax the corporation on the imputed time-value element.[333]

[333] Advocates of the proposal would observe that so long as the forward price is higher than the market price on the contract date, there is at least a "profit" established in the forward contract (representing the time-value component of the contract) that should be taxable regardless of whether that profit is higher or lower than in it otherwise would be in the absence of the contract.

Some have suggested that a more narrowly tailored solution could be developed to address the perceived abuse of a corporation in essence being able to make a tax-free, fixed-income investment in its own stock (i.e., the "cash and carry transaction"). Under such an approach, the corporation would recognize taxable gain only if it acquired its own stock and on a substantially contemporaneous basis entered into a forward contract to sell its own stock and substantially all of its expected return from the transaction was attributable to the time value of money invested.[334]

Finally, some would argue that the provision narrowly focuses on one type of derivative contract with respect to a corporation's own stock and that a broader approach addressing the treatment under section 1032 of derivative contracts and other techniques for using a corporation's own stock would be more appropriate. Otherwise, the inconsistent treatment of economically equivalent transactions under section 1032 and the uncertainty as to its scope, in particular with respect to its applications to derivative contracts in a corporation's own stock, could result in whipsaw against the government. Those who espouse this view would argue that consideration should be given to a range of alternative approaches for addressing the issue of derivatives and section 1032, including (1) expanding the scope of section 1032 to cover all derivatives in a corporation's stock, or (2) contracting the scope of section 1032 to cover only transactions in which a corporation issues or purchases its own stock for fair market value.[335]

Prior Action

An identical proposal was included in the President's fiscal year 2000, 2001, and 2010 budget proposals.

3. Require ordinary treatment for dealer activities with respect to section 1256 contracts

Present Law

In general

In general, gain or loss on the sale of stock in trade of a taxpayer or other property of a kind that properly would be included in inventory, or property that is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, is treated as ordinary income.[336] Consistent with this general rule, a taxpayer's status as a "dealer" in a particular type of property generally means that the taxpayer recognizes ordinary gain or loss when it engages in its day-to-day dealer activities, namely selling or exchanging the type of property for which it is a dealer.

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[334] See New York State Bar Association, *Report on Section 1032*, 1999 TNT 199-22 (Jun. 22, 1999).

[335] New York State Bar Association, *Report on Section 1032*.

[336] Sec. 1221(a)(1).

A dealer in securities must compute its income pursuant to the mark-to-mark method of accounting.[337] Any security that is inventory in the hands of the dealer must be included in inventory at its fair market value; in the case of any security that is not inventory and that is held at the end of the taxable year, the dealer must recognize gain or loss as if the security had been sold for its fair market value. The resulting gain or loss generally is treated as ordinary gain or loss.[338]

<u>Section 1256 contracts</u>

Notwithstanding the general rule applicable to dealers, special rules apply to gains and losses of commodities dealers, commodities derivative dealers, dealers in securities, options dealers, and dealers in securities futures contracts or options with respect to "section 1256 contracts." Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss (the "60/40 rule").[339] Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[340] A taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.[341]

A "section 1256 contract" is any (1) regulated futures contract; (2) foreign currency contract; (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.[342] The term "section 1256 contract" does not, however, include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[343]

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[337] Sec. 475(a).

[338] Sec. 475(d)(3).

[339] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

[340] Sec. 1256(c)(1).

[341] Sec. 1212(c).

[342] Sec. 1256(b). The term "section 1256 contract" does not include any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract.

[343] Sec. 1256(b)(2).

Dealers in section 1256 contracts

A "commodities dealer" is any person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.[344] Commodities dealers recognize capital gains and losses with respect to their section 1256 contracts unless they elect to have the rules of section 475 apply.[345]

A "commodities derivatives dealer" is a person that regularly offers to enter into, assume, offset, assign, or terminate positions in "commodities derivative financial instruments" with customers in the ordinary course of a trade or business.[346] Commodities derivative financial instruments held by a commodities derivatives dealer generally are not capital assets, and the sale or exchange of such instruments by a commodities derivatives dealer results in ordinary gain or loss.[347] However, the definition of "commodities derivative financial instruments" excludes section 1256 contracts.[348] As a result, the gains and losses of commodities derivatives dealers with respect to section 1256 contracts typically are capital under the general rules of section 1256.

A "dealer in securities" is a taxpayer who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[349] The general rules applicable to securities dealers do not apply to section 1256 contracts held by security dealers. As a result, the gains and losses of dealers in securities with respect to section 1256 contracts typically are capital under the general rules of section 1256.

An "options dealer" is any person registered with a national securities exchange as a market maker or specialist in listed options, as well as any person whom the Secretary determines performs similar functions.[350] An option dealer's transactions with respect to both

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[344] Sec. 1402(i)(2)(B).

[345] Sec. 1256(f)(3).

[346] Sec. 1221(b)(1)(A).

[347] Sec. 1221(a)(6).

[348] Section 1221(b)(1)(B) provides that the term "commodities derivative financial instrument" means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b))), the value or settlement price of which is calculated by or determined by reference to a "specified index." A specified index means any one or more or any combination of (1) a fixed rate, price, or amount, or (2) a variable rate, price, or amount, which is based on any current, objectively determinable financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the parties' circumstances.

[349] Sec. 475(c)(1).

[350] Sec. 1256(g)(8).

non-equity options and dealer equity options, both of which are section 1256 contracts, give rise to capital gain or loss under section 1256.[351]

A person is treated as a "dealer in securities futures contracts or options on such contracts" if the Secretary determines that such person performs, with respect to such contracts or options, as the case may be, functions similar to functions performed by an options dealer.[352] Dealer securities futures contracts are section 1256 contracts, and the transactions of a dealer in securities futures contracts with respect to such contracts give rise to capital gain or loss.[353]

Description of Proposal

The proposal requires commodities dealers, commodities derivatives dealers, dealers in securities, and options dealers to treat the income from their day-to-day dealer activities with respect to section 1256 contracts as ordinary in character, not capital. The proposal does not affect the application of the mark-to-market rules with respect to such gains and losses.

Effective date.−The proposal is effective for tax years beginning after the date of enactment.

Analysis

The proposal provides that a commodities dealer's, commodities derivative dealer's, securities dealer's, and an option dealer's gains and losses with respect to section 1256 contracts are treated as ordinary income. The proposal thus denies such dealers the benefits of the 60/40 rule, but allows net losses to be taken into account without regard to any capital loss limitations. The proposal does not otherwise affect the present-law requirement that such dealers report their section 1256 gains and losses under the mark-to-market method.

The 60/40 rule provides favorable treatment for certain dealers with respect to income that otherwise would not qualify for preferential capital gains treatment. This special treatment is not currently relevant in the case of corporate dealers because corporate capital gain is taxed at the same tax rates as ordinary income. For individuals, however, the 60/40 rule results in a maximum tax rate of 26 percent on their business income. Proponents argue that eliminating the

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[351] Sec. 1256(f)(3). This section, added as part of the Deficit Reduction Act of 1984 (H.R. 4170, Pub. L. No. 98-369), changed the rules for options market makers. Prior to the enactment of section 1256(f)(3), some options market makers took the position that options with respect to which they made a market were granted or acquired in the course of a trade or business. As a consequence, they maintained that transactions with respect to such options gave rise to ordinary income or loss. *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 302.

[352] Sec. 1256(g)(9).

[353] Section 1256(g)(9)(A) provides that a "dealer securities futures contract" means, with respect to any dealer, any securities futures contract, and any option on such a contract, which (1) is entered into by such dealer (or, in the case of an option, is purchased or granted by such dealer) in the normal course of his activity of dealing in such contracts or options, as the case may be, and (2) is traded on a qualified board or exchange.

60/40 rule for dealers is appropriate, because their business income should be taxed in the same manner as dealers of other types of property.[354]

On the other hand, Congress implicitly has acknowledged that the day-to-day activity of commodities dealers and options dealers with respect to section 1256 contracts is in fact "trading."[355] And section 1256(f)(3)(A), which provides that "trading" section 1256 contracts gives rise to capital gain or loss, is arguably nothing more than a codification of a basic tax principle. Thus, the Administration's proposal also could be viewed (at least with respect to commodities dealers and options dealers) as creating a special character rule for certain categories of traders.

Furthermore, some will contend that the 60/40 rule, which was enacted in 1981 and expanded in 1984 and 2000, was intended to provide the benefit of a lower rate for these taxpayers who, by virtue of the enactment of the mark-to-market regime, were being required to pay tax with respect to gains prior to their realization. For purposes of determining a taxpayer's holding period, applying a mark-to-market method to capital assets creates uncertainty and complexity if a mark when the asset is still short term is followed by a second mark after the long-term holding period has been reached.[356] The 60/40 rule could be viewed as ameliorating these aspects of the mark-to-market regime and, therefore, its retention may be appropriate. Others would respond by noting that these concerns have become less significant since the 1993 enactment of section 475, which mandates mark-to-market treatment (and ordinary gain or loss) for dealers in securities.[357]

[354] See, e.g., Erika W. Nijenhuis, *Taxation of Securities Futures Contracts*, 792 PLI/Tax 103, 121 (2007) ("The 60/40 treatment provided by section 1256 is, however, a complete distortion of the Code's character rules, in two respects. First, it accords capital rather than ordinary treatment to taxpayers (dealers) who are acting in the normal course of their business activities. It does so, moreover, without imposing the normal limitations on the deductibility of capital losses, through a special rule that permits non-corporate taxpayers to carry back losses from section 1256 contracts to offset gains in prior years from such contracts. [Section 1212(c)] Second, it accords preferential long-term capital gain rates to taxpayers who have not made the long-term investment in capital assets that the rate differential is intended to encourage.").

[355] See Sec. 1402(i)(2)(B) (defining a "commodities dealer" as a person who is actively engaged in *trading* section 1256 contracts). Section 1256(f)(3), which by its terms is applicable to "trading" section 1256 contracts, was enacted for the purpose of codifying the character rules for commodities dealers and changing the character rules for options market makers, i.e., options dealers. *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 312.

[356] Even in the absence of the mark-to-market rules in section 1256, it is not clear that many traders would have a long-term holding period with respect to their section 1256 contracts. Traders make money by trading in and out of positions, not by buying and holding positions. Moreover, many section 1256 contracts, commodities futures in particular, have settlement dates that are less than one year from the date on which the parties initially enter into the contract.

[357] In 1997, section 475 was expanded to include an elective regime for commodities dealers (and traders in commodities and securities).

Prior Action

A similar proposal was included in the President's fiscal year 2001 and 2010 Budget Proposals.

4. Modify the definition of control for purposes of the section 249 deduction limitation

Present Law

In general, where a corporation repurchases its indebtedness for a price in excess of the adjusted issue price, the excess of the repurchase price over the adjusted issue price (the "repurchase premium") is deductible as interest.[358] However, in the case of indebtedness that is convertible into the stock of (1) the issuing corporation, (2) a corporation in control of the issuing corporation, or (3) a corporation controlled by the issuing corporation, section 249 provides that any repurchase premium is not deductible to the extent it exceeds "a normal call premium on bonds or other evidences of indebtedness which are not convertible."[359]

For purposes of section 249, the term "control" has the meaning assigned to such term by section 368(c). Section 368(c) defines "control" as "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." Thus, section 249 can apply to debt convertible into the stock of the issuer, the parent of the issuer, or a first-tier subsidiary of the issuer.

Description of Proposal

The proposal modifies the definition of "control" in section 249(b)(2) to incorporate indirect control relationships, of the nature described in section 1563(a)(1). Section 1563(a)(1) defines a parent-subsidiary controlled group as one or more chains of corporations connected through stock ownership with a common parent corporation if (1) stock possessing 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, except the common parent corporation, is owned (within the meaning of subsection (d)(1)) by one or more of the other corporations; and (2) the common parent corporation owns (within the meaning of subsection (d)(1)) stock possessing 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

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[358] See Treas. Reg. sec. 1.163-7(c).

[359] Regulations under section 249 provide that "[f]or a convertible obligation repurchased on or after March 2, 1998, a call premium specified in dollars under the terms of the obligation is considered to be a normal call premium on a nonconvertible obligation if the call premium applicable when the obligation is repurchased does not exceed an amount equal to the interest (including original issue discount) that otherwise would be deductible for the taxable year of repurchase (determined as if the obligation were not repurchased)." Treas. Reg. sec. 1.249-1(d)(2). Where a repurchase premium exceeds a normal call premium, the repurchase premium is still deductible to the extent that it is attributable to the cost of borrowing (e.g., a change in prevailing yields or the issuer's creditworthiness) and not attributable to the conversion feature. See Treas. Reg. sec. 1.249-1(e).

stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

Effective date.−The proposal is effective on the date of enactment.

Analysis

Section 249 was added to the Code in 1969, and has not been altered substantially in 40 years. The reason for the original provision was explained by the staff of the Joint Committee on Taxation in 1969: "A corporation which repurchases its convertible indebtedness is, in part, repurchasing the right to convert the bonds into its stock. Since a corporation may not deduct the costs of purchasing its stock as a business expense, the Congress believed that the purchase of what, in effect, is the right to purchase its stock should be treated in the same manner."[360] The extension of the basic rule of section 249 to the stock of a corporation in control of the issuer or a corporation controlled by the issuer can be viewed simply as an anti-avoidance measure.

The Administration now proposes to bolster the anti-avoidance rule by expanding the definition of "control." According to the Administration: "The definition of 'control' in section 249 is unnecessarily restrictive, and has resulted in situations in which the limitation in section 249 is too easily avoided. Indirect control relationships (e.g., a parent corporation and a second-tier subsidiary) present the same economic identity of interests as direct control relationships, and should be treated in a similar manner."

Similar changes have been proposed by others in the past. For instance, a 1987 report of the Tax Section of the New York State Bar Association noted: "Section 249 applies only to debt instruments convertible into stock of the issuer or a corporation controlled by or controlling the issuer, using the section 368(c) definition of control. This definition is overly narrow in some respects (e.g., a class of nonvoting preferred stock held by a third party would avoid a finding of control, and ownership attribution is not taken into account), and a statutory amendment to adopt a broader definition seems warranted."[361]

Prior Action

The same proposal was included in the President's 2010 fiscal year budget proposal.

[360] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 131.

[361] New York State Bar Association Tax Section, *Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations*, in Tax Notes, January 26, 1987, p. 363 at p. 421 fn. 135; *see also* Lee A. Sheppard, *A Real Mickey Mouse Deal (Or Can Disney Beat Section 249?)*, 47 Tax Notes 1282 (June 11, 1990) (noting that "[o]thers have argued that the section 1504(a) standard should be used, so that section 249 would look through affiliated corporations").

B. Reinstate Superfund Excise Taxes and Corporate Environmental Income Tax

Present Law

The Superfund program addresses cleanup activity of hazardous substances at contaminated sites. Before January 1, 1996, four taxes were imposed to fund the Hazardous Substance Superfund Trust Fund ("Superfund"):

1. An excise tax on petroleum and imported refined products;[362]
2. An excise tax on certain hazardous chemicals, imposed at rates that varied from $0.22 to $4.87 per ton;[363]
3. An excise tax on imported substances made with the chemicals subject to the tax in (2), above;[364] and
4. An income tax on corporations calculated using the alternative minimum tax rules.[365]

The taxes expired at the end of 1995. At the time the taxes expired, the Superfund Trust Fund had an unobligated balance of $4 billion.[366] By Fiscal Year 2004, the unobligated balance was zero.[367] As a result, the Superfund program has had to rely on general fund appropriations to fund the program.

The Environmental Protection Agency ("EPA") compiles the National Priorities List, which includes sites that the EPA has identified as having the greatest risk to human health and the environment. In many cases, potentially responsible parties ("PRPs") pay for the cleanups. Potentially responsible parties are responsible for more than 70 percent of the sites on the National Priorities List.[368] At approximately 30 percent of the National Priorities List sites, the EPA cannot locate the PRPs for these properties or the PRPs that are located do not have the

[362] Sec. 4611(c)(2)(A).

[363] Sec. 4661.

[364] Sec. 4671.

[365] Sec. 59A.

[366] Congressional Research Service, *Superfund Taxes or General Revenues: Future Funding Issues for the Superfund Program* (February 4, 2008) at 3.

[367] *Ibid.* at 4.

[368] *Ibid.* at 1.

financial resources to cover the cleanup.[369] For this group of sites ("orphan sites"), the EPA uses funds from the Superfund to conduct cleanup activities.

Description of Proposal

The proposal reinstates the three Superfund excise taxes for periods after December 31, 2010. It would also reinstate the corporate environmental income tax for taxable years beginning after December 31, 2010. Both the excise and corporate income taxes would sunset after December 31, 2020.

Effective date.−The proposals are effective for periods after December 31, 2010 (for the Superfund excise taxes) and for taxable years beginning after December 31, 2010 (for the corporate environmental income tax).

Analysis

Some contend that the Superfund program has been underfinanced since the taxes that supported it expired in 1995 and that such underfunding has slowed the progress of cleaning up hundreds of orphan sites.[370] Thus proponents assert that the taxes dedicated to the trust fund should be reinstated to meet the continuing cleanup needs of orphan sites.

Opponents of the reinstatement of the taxes argue that the persons bearing the burden of the taxes are not the ones directly responsible for the contamination. They argue that the cleanup of orphan sites is a broad societal problem that should be paid for by general revenues instead of levy on particular industries.[371] In contrast, some proponents argue that under a "polluter pays" principle, cleanup of the orphan sites should come from the industries that profited from the sale or use of the chemicals being cleaned up, even if those parties are not directly related to a particular release of a hazardous substance. Some have taken a more narrow view of "polluter pays" to include only those directly responsible for the contamination and assert that it is unfair to impose a tax on a person to compensate for another's transgression. Some would argue that even under the broader theory of "polluter pays," the corporate environmental income tax is inconsistent with this theory because the tax is imposed without regard to the particular product the corporation manufactures.

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[369] *Ibid.*

[370] See Congressional Research Service, *Superfund Taxes or General Revenues: Future Funding Issues for the Superfund Program,* February 4, 2008, at CRS-8 and John W. Broder, New York Times, "Without Superfund Tax, Stimulus Aids Cleanups," April 25, 2009, at A16.

[371] American Petroleum Institute, Superfund Taxes (2009), available at <http://www.api.org/policy/tax/taxpositions/upload/Tax_Superfund.pdf>; American Chemistry Council, *Issue Brief: Superfund Taxes,* March 24, 2009.

Prior Action

The same proposals were included in the President's fiscal year 2010 budget proposal.[372]

[372] A similar proposal was included among the Fiscal Year 1999 budget proposals. See, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal* (JCS-4-98), February 24, 1998 at 225. The Clinton Administration requested reinstatement of the taxes annually in its budget submissions but Congress did not enact the proposal. Congressional Research Service, *Superfund Taxes or General Revenues: Future Funding Issues for the Superfund Program,* February 4, 2008, at CRS-4.

C. Permanent Extension of Federal Unemployment Surtax

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through the first six months of 2011.

Description of Proposal

The proposal permanently extends the temporary surtax rate.

Effective date.−The proposal is effective for labor performed after June 30, 2011.

Analysis

The proposal reflects the belief that a surtax extension is needed in order to increase funds for the Federal Unemployment Trust Fund to provide a cushion against future Trust Fund expenditures. The monies retained in the Federal Unemployment Account of the Federal Unemployment Trust Fund can then be used to make loans to the 53 State Unemployment Compensation benefit accounts as needed.

As a tax on labor, the FUTA tax is thought to be borne by labor in the long run in the form of lower wages, rather than borne by the employers, who have the statutory obligation to pay the tax. Though the economic incidence of the tax falls on labor, so too do the benefits, in the form of unemployment compensation paid during future spells of unemployment.

Prior Action

No prior action.

D. Repeal Last-In, First-Out Inventory Accounting Method

Present Law

In general

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[373]

Under the last-in, first-out ("LIFO") method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.[374] Compared to first-in, first-out ("FIFO"), LIFO produces net income which more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory is generally not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which sales exceed purchases.[375]

Dollar-value LIFO

Under a variation of the LIFO method, known as dollar-value LIFO, inventory is measured not in terms of number of units but rather in terms of a dollar-value relative to a base cost. Dollar-value LIFO allows the "pooling" of dissimilar items into a single inventory calculation. Thus, depending upon the taxpayer's method for defining an item, LIFO can be applied to a taxpayer's entire inventory in a single calculation even if the inventory is made up of different physical items. For example, a single dollar-value LIFO calculation can be performed for an inventory that includes both yards of fabric and sewing needles. This effectively permits the deferral of inflationary gain to continue even as the inventory mix changes or certain goods previously included in inventory are discontinued by the business.

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[373] Sec. 471(a) and Treas. Regs. sec. 1.471-1.

[374] Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward to the beginning inventory of the following year. Sec. 472(b).

[375] Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (and inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

Simplified rules for certain small businesses

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.[376] In doing so, the Congress acknowledged that the LIFO method is generally considered to be an advantageous method of accounting, and that the complexity and greater cost of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.[377]

To qualify for the simplified method, a taxpayer must have average annual gross receipts of $5 million or less for the three preceding taxable years.[378] Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.

Special rules for qualified liquidations of LIFO inventories

In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 of the Code mitigates the adverse effects in certain specified cases by allowing a taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period. The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade.

Description of Proposal

The proposal repeals the LIFO inventory accounting method. Taxpayers that currently use LIFO would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. The resulting increase in income is taken into account ratably over 10 taxable years beginning with the first taxable year beginning after December 31, 2011.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

In general, assuming rising prices, taxpayers using LIFO have an incentive to maintain or build inventory levels rather than allowing them to fall. So long as inventory levels are steady or growing the taxpayer never is deemed to have sold any of its older, lower-cost inventory, and inflationary gain is deferred indefinitely. However, in a period in which the inventory level falls,

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[376] Sec. 474(a).

[377] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514),* (JCS-10-87), May 4, 1987, p. 482.

[378] Sec. 474(c).

the taxpayer necessarily will (absent a special rule) be deemed to have sold some units purchased in a prior period, and the inflationary gain in those periods will be recognized in taxable income.[379]

Proponents of the LIFO method argue that in periods of rising costs, the method provides the most accurate reflection of current-period economic income because it matches current costs against current sales revenues. They point out that the taxpayer will have to replace the inventory to continue in business and that by including the most recent additions to the inventory in cost of goods sold, the required cost of replacing the inventory is more closely projected.[380]

Alternatively, proponents of the FIFO method argue that LIFO permits deferral of inflationary gains in a taxpayer's inventory even when those gains arguably have been realized by the business. They note that outside of the inventory context, inflationary gains are generally taxed when the gain is realized (i.e., upon sale of the appreciated asset) and LIFO offers self-help against inflation that is not available in other contexts. FIFO proponents further assert that the use of earlier acquired items to value ending inventory understates net worth in times of rising prices resulting in an understatement of the income that measures the change in net worth for a given period.[381]

Proponents of FIFO also argue that a business whose inventory turns over with regularity during a taxable year should not value inventory as if it includes items purchased in prior years. However, LIFO advocates counter that, although there may be inventory turnover, it is highly unlikely that there is a time when there are no units in inventory. They view this perpetual inventory "layer" as a required condition of doing business and best valued at the time the layer was established, which is accomplished under LIFO. Thus, supporters of LIFO argue that during inflationary periods, using LIFO enables a business to finance its increasing need for capital to

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[379] By contrast, inflationary gain is generally recognized in earlier periods under the FIFO method, so taxpayers using FIFO do not have a similar incentive to maintain or build inventory levels.

[380] See, e.g., LIFO Coalition letter to then-Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 TNT 125-18), wherein author Leslie J. Schneider explains that, "If a business is faced with the situation that, because of inflation, each time that it sells any item from its inventory, it must expend a larger amount of capital than the FIFO cost of the item to simply replace the item of inventory that has been sold, the business would continually be required to increase its capital investment in inventory to simply maintain the status quo. Presumably, this increased capital investment would ordinarily be financed from the proceeds of the sale of the inventory, but if that profit were taxed on a FIFO basis, the after-tax proceeds from the sale of the inventory would in many cases not be sufficient to finance the acquisition of the necessary replacement inventory."

[381] Commentators favoring FIFO have also noted that since ending inventory under LIFO can be controlled through the purchase of additional units at year-end, LIFO is susceptible to manipulation by taxpayers through timing year-end purchases or sales of inventory. See, e.g., Testimony of George A. Plesko before the Committee on Finance United States Senate, June 13, 2006. However, proponents of LIFO point out that court decisions and IRS rulings effectively preclude taxpayers from acquiring unneeded inventory at year end to avoid liquidation of low-cost LIFO layers. See, LIFO Coalition letter to Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 TNT 125-18).

maintain physical inventory levels. In this respect, they note that LIFO functions much like accelerated depreciation for capital investment in productive machinery and equipment.[382]

Commentators contend that LIFO and, more specifically dollar-value LIFO (the most commonly used method of valuing inventory under LIFO), does not simply isolate changes in inventory cost resulting from inflation, but includes increases and decreases due to other factors outside of normal inflation such as changes in technology and changes in relative values as market supply and demand changes.[383] These commentators also note that a taxpayer's definition of an "item" for purposes of establishing its dollar-value LIFO pools can result in changes to inventory costs that are not attributable solely to inflation.[384] For example, a broad item definition generally results in fewer pools lessening the likelihood that a previously established LIFO layer will be liquidated, which has the effect of deferring gain which results not from inflation, but from a change in the goods that comprise a particular dollar-value LIFO pool.

Supporters of LIFO have also pointed out the potential adverse economic effects of the recapture of the LIFO reserve, especially for those businesses that have used LIFO for decades. The tax imposed on the recapture of the reserve, even where the recapture is spread over a period of years (e.g., eight as is currently proposed), could be substantial, and could severely restrict the ability of such taxpayers to invest in capital, including maintaining their current physical inventory levels.[385]

Unlike U.S. Generally Accepted Accounting Principles ("GAAP"), international financial reporting standards ("IFRS") do not treat LIFO as a permitted method of accounting.[386] The Securities and Exchange Commission ("SEC") recently indicated its support for global accounting standards and it continues to work toward making a determination by 2011 as to whether to incorporate IFRS into the U.S. financial reporting system. SEC staff also noted that if the SEC were to decide to move to IFRS, the transition date for U.S. issuers would be no earlier

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[382] LIFO Coalition letter to then-Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 TNT 125-18). See also, Alan D. Viard, "Why LIFO Repeal is Not the Way to Go," *Tax Notes*, Nov. 6, 2006, p. 574.

[383] See Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, "Is it Time to Liquidate LIFO?" *Tax Notes*, Oct. 16, 2006, p. 237.

[384] *Ibid.*

[385] See, e.g., Small Business Administration: Office of Advocacy letter to the Tax Reform Subcommittee of the Presidential Economic Recovery Advisory Board dated September 29, 2009, noting that "eliminating the ability to use LIFO would result in a tax increase for small business that could ultimately force many small businesses to close," http://www.sba.gov/advo/laws/comments/tax09_0929.html.

The potentially adverse effect of the repeal of LIFO could be moderated by modifying the LIFO reserve recapture, for example, specifying partial reserve recapture based on business size or other mitigating factors, or extending the spread period for recapturing the LIFO reserve.

[386] International Accounting Standards Board, International Accounting Standard (IAS) No. 2, *Inventories*, (rev. 2003).

than 2015.[387] The seemingly inevitable shift from GAAP to IFRS raises the issue of whether companies will be able to continue using LIFO for tax purposes in light of the conformity requirement.[388]

Prior Action

A similar proposal for the repeal of LIFO was included in the President's budget proposal for fiscal year 2010.[389]

[387] See February 24, 2010, remarks of SEC Chair Mary Shapiro and SEC Chief Accountant James Kroeker (2010 TNT 37-6). Previously, the SEC had proposed full adoption of IFRS by large U.S. companies by 2014. See RIN 3235-AJ93, 73 Fed. Reg. 70816 (November 21, 2008).

[388] Some commentators have noted that the conformity requirement is a requirement "in form only" because changes to the regulations allow alternative inventory valuations be disclosed in the financial statements provided the face of the income statement reflects LIFO. See Michael J. R. Hoffman and Karen S. McKenzie, "Must LIFO Go to Make Way for IFRS?" *The Tax Adviser* (March 2009).

[389] A proposal to repeal LIFO was included in H.R. 3970 (introduced October 25, 2007).

E. Repeal Gain Limitation on Dividends Received in Reorganization Exchanges

Present Law

Distributions and stock redemptions in general

If a corporation distributes cash (or other property not permitted to be received without tax)[390] to its shareholders who do not surrender stock in a redemption, the distribution is generally treated as a dividend to the shareholders, to the extent of the corporation's current and accumulated earnings and profits.[391] Amounts in excess of such earnings and profits are treated as recovery of a shareholder's stock basis, and then as capital gain to the extent in excess of such basis.

If a corporation redeems its stock and one of four tests is satisfied, the redeemed shareholder treats the redemption as a sale or exchange.[392] This allows the shareholder to reduce the amount included in income by his basis in the redeemed stock and also entitles the shareholder to capital gain (or loss) treatment. If none of the tests is met, the redemption is treated as a dividend to the extent that the distribution is either out of accumulated earnings and profits or out of earnings and profits for the current year.

The four tests are: (1) the redemption is not essentially equivalent to a dividend; (2) the distribution is substantially disproportionate with respect to the shareholder (i.e., the shareholder's ownership of voting stock and common stock declines by more than 20 percent as a result of the redemption and the shareholder owns less than 50 percent of the voting stock after the redemption); (3) the shareholder's interest is completely terminated; and (4) a shareholder (other than a corporation) is redeemed in partial liquidation of the distributing corporation.

Whether dividend treatment or sale treatment is more advantageous to the recipient depends upon the recipient's tax situation. Dividend treatment (outside of the special rules applicable in a corporate reorganization, discussed later below) does not allow a shareholder to limit its income by the benefit of any stock basis recovery. However, dividend treatment can be advantageous to a corporate shareholder, depending upon the circumstances, because in the domestic context a corporate recipient generally would be entitled to a dividends-received deduction of at least 70 percent, and possibly all, of the amount of the dividend, depending on stock ownership[393] (or would eliminate the dividend if it is filing a consolidated return with the

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[390] Certain distributions of stock to shareholders with respect to a corporation's stock are permitted to be received tax free (sec. 305) as are certain distributions of stock, or of securities to the extent of securities surrendered, in tax free reorganizations or section 355 divisive transactions. Section 351 contains rules permitting the tax-free receipt of certain stock in exchange for property contributed to a corporation.

[391] Sec. 301.

[392] Sec. 302.

[393] Sec. 243.

payor).[394] If the recipient is a foreign person and the payor is a U.S. corporation, dividends are generally subject to withholding tax, a result generally less favorable than non-taxed capital gain treatment from a stock redemption treated as a sale of the stock. However, the amount of withholding tax on dividends is reduced under many treaties. If the payor is a foreign corporation, U.S. shareholders may be entitled to foreign tax credits with respect to a dividend. On the other hand, if basis is allowed to offset the amount of income from the distribution, then the transfer of stock with a high basis for cash or other property may be largely or entirely nontaxable.

The earnings and profits of a corporation paying a distribution that is a dividend are reduced by the entire amount of the dividend. If a distribution in redemption of stock is treated as a sale or exchange, then the amount of the distribution properly chargeable to earnings and profits is limited to the ratable share of the earnings and profits attributable to the redeemed stock.[395]

Section 304

Under section 304(a)(1), if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation (the "target") from the person (or persons) so in control, then for purposes of section 302 and 303, the property shall be treated as a distribution in redemption of the stock of the acquiring corporation. The tests described above to determine the tax treatment of a stock redemption apply to determine whether the transfer is treated as an exchange or as a distribution of property. To the extent the deemed property distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated in the same manner as if (1) the transferor had transferred the acquired stock of the target corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then transferred the property to the transferor in redemption of the stock it is deemed as having issued.[396] In the case of a section 304 transaction, both the amount and source of any dividend are determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits, and then by the target (i.e., issuing) corporation to the extent of its earnings and profits.[397]

Special rules apply if the acquiring corporation in a section 304 transaction is a foreign corporation.[398] The foreign acquiring corporation's earnings and profits that are taken into account to determine the amount and source of a dividend are limited to the portion of such

[394] Treas. Reg. sec. 1.1502-13(f).

[395] Sec. 312(n)(7).

[396] Sec. 304(a)(1).

[397] Sec. 304(b)(2).

[398] Sec. 304(b)(5).

earnings and profits that (1) are attributable to stock of the foreign acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) of the target corporation and who is a U.S. shareholder (within the meaning of section 951(b)) of the foreign acquiring corporation and (2) were accumulated while such stock was owned by the transferor (or a person related thereto) and while the foreign acquiring corporation was a controlled foreign corporation ("CFC").

Boot in reorganizations and certain 355 distributions

In general, gain or loss is not recognized with respect to exchanges of stock and securities by a shareholder in corporate reorganizations (or section 355 divisive stock distributions). However, if such an exchange also involves the receipt of nonqualifying consideration ("boot"), then the shareholder must recognize gain (if any) to the extent of the boot received in the exchange. No loss is allowed.[399] Further, part or all of that gain may be taxable as a dividend if the exchange has the effect of a distribution of a dividend. Unlike the rules that apply to ordinary dividends, under the boot dividend rules of section 356(a)(1), the amount of a dividend recognized by the exchanging shareholder is limited to the amount of gain recognized by the shareholder on the exchange. Also, under the boot dividend rules, a shareholder's dividend income recognized is limited to "such an amount of the gain recognized as is not in excess of his ratable share of undistributed earnings and profits of the corporation accumulated after February 28, 1913."[400] The remainder of the gain recognized, if any, is treated as gain from the exchange of property.

The courts and the IRS have held that the principles developed in interpreting the rules relating to stock redemptions are applicable in determining whether boot received in a reorganization exchange or a section 355 exchange is treated as a dividend. In *Clark v. Commissioner*,[401] the Supreme Court explicitly applied the substantially disproportionate test of the stock redemption rules in the reorganization context by analyzing whether the distribution is substantially disproportionate with respect to the shareholder (i.e., the shareholder's ownership of voting stock and common stock declines by more than 20 percent as a result of the redemption and the shareholder owns less than 50 percent of the voting stock after the redemption). This test was applied by treating the boot as being paid in redemption of additional stock hypothetically received by the exchanging shareholder and applying the tests under section 302. Nevertheless, there is no explicit statutory coordination between the stock redemption rules and the rules relating to the treatment of boot received in a reorganization exchange or section 355 exchange.

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[399] Sec. 356(c).

[400] Section 356(a)(2). Courts have interpreted a reference to earnings and profits accumulated to include current earnings and profits for the year of the distribution. See, e.g., *James Armour, Inc. v Commissioner*, 43 T.C. 295 (1965); *Weaver v. Commissioner*, 25 T.C. 1067 (1956); *Vesper Co. v. Commissioner*, 131 F. 2d 200 (8th Cir. 1942). The scope of the latter two cases as applied to section 356(a)(2), and the application of the ratable share language under that section, are potentially unclear.

[401] 489 U.S. 726 (1989).

As discussed above, under section 356(a) boot will only be treated as a dividend to the extent of the exchanging shareholder's ratable share of the corporation's undistributed earnings and profits. The IRS has ruled, and at least one circuit court has held under present law that, for purposes of determining the deemed dividend under section 356(a)(2), the earnings and profits of the target (i.e., transferor) and the acquiring (i.e., transferee) corporation should both be taken into account when the corporations are commonly owned.[402] Other courts, however, have held that only the earnings and profits of the target corporation are taken into account even in the case of common ownership.[403]

If an exchange described in section 356(a)(1) has the effect of a distribution of a dividend, the earnings and profits from which it is considered to be paid are reduced by the entire amount that is taxable as a dividend to the shareholder. In a ruling issued prior to the enactment of section 312(n)(7), which limits the reduction of earnings and profits in a section 302 redemption to the ratable share attributable to the redeemed stock, the IRS ruled that in a dividend equivalent transaction under section 356(a)(2), earnings and profits are also reduced by the amount that exceeds the shareholder's ratable share of earnings and profits and that is taxed to the shareholder as capital gain.[404] There is a lack of clarity under present law whether the limitation on the reduction of earnings and profits under section 312(n)(7) applies in the case of a reorganization.

Some reorganizations (under sections 368(a)(1)(D),[405] (E),[406] and (F)[407]) necessarily involve corporations under common control, or a single corporation. Other reorganizations also

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[402] Rev. Rul. 70-240, 1970-1 C.B. 81; *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied 386 U.S. 1022 (1967).

[403] *American Mfg. Co. v. Commissioner,* 55 T.C. 204 (1970); *Atlas Tool Co. v. Commissioner*, 70 T.C. 86 (1978), aff'd 614 F.2d 860 (3d Cir. 1980), cert. denied 449 U.S. 386 (1980).

[404] Rev. Rul. 72-327, 1972-2 C.B. 197.

[405] The transfer of assets by a transferor corporation to another corporation, controlled (immediately after the transfer) by the transferor or one or more of its shareholders, will qualify as a tax-free reorganization under section 368(a)(1)(D) if certain requirements are met. These requirements generally are that (1) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor corporation followed by, in effect, a complete liquidation of the transferor corporation, or (2) the transfer is made by one corporation of a part of its assets consisting of an active trade or business meeting certain requirements to a controlled subsidiary corporation, followed by the distribution of the stock and securities of the controlled subsidiary in a divisive spin-off, split-off, or split-up which was not used principally as a device for the distribution of earnings and profits.

If, pursuant to an integrated plan, a parent corporation sells the stock of a subsidiary to another subsidiary and the acquired subsidiary liquidates into the acquiring subsidiary, the transaction is a tax-free reorganization. Rev. Rul. 2004-83, 2004-2 C.B. 157. This holds true, whether or not there is an actual issuance of stock, to the extent the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions. Treas. Reg. sec. 1.368-2(l) (see T.D. 9475, 2010-4 I.R. B. 304).

[406] Section 368(a)(1)(E) refers to a recapitalization.

[407] Section 368(a)(1)(F) refers to a mere change in identity, form, or place of organization of one corporation, however effected.

may involve continuing common ownership such that as to a particular shareholder, boot received may be treated as a dividend.

Certain cross-border reorganizations under section 367

In general, to the extent that transactions include certain cross-border transfers, the provisions of section 367(a) and (b) apply to (i) preserve the U.S. ability to tax gains attributable to the accrued appreciation in assets that leave the U.S. tax system and (ii) require the inclusion of previously untaxed foreign earnings of certain foreign subsidiaries (hereinafter the "earnings repatriation purpose").[408] Thus, section 367(a)(1) provides that if, in connection with certain exchanges under subchapter C of the Code, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered a corporation.[409] By deeming the foreign corporation not to be a corporation, the provision precludes the transfer from qualifying as tax-free under subchapter C. The Secretary has broad regulatory authority under section 367(a)(2), (3) and (6) to provide that section 367(a)(1) will or will not apply to certain transfers described therein.

Section 367(b) applies to certain exchanges in which there is no transfer of property described in section 367(a)(1).[410] Section 367(b)(1) provides that a foreign corporation shall be considered to be a corporation, except to the extent provided in regulations in order to prevent the avoidance of Federal income taxes. Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing, among other things, the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

In recent years, Treasury has focused on certain transaction structures that are inconsistent with section 367(a) and (b). Two recent examples include the transactions commonly referred to as "Killer B" transactions and transactions referred to as "Deadly D" transactions.[411]

[408] H.R. Rep. No. 94-658 (Nov. 12, 1975).

[409] The exchanges described under the general rule of section 367(a)(1) include: (1) complete liquidations of subsidiaries under section 332; (2) transfers to controlled corporations under section 351; (3) exchanges of stock and securities in certain reorganizations under section 354; (4) the distribution of stock and securities of a controlled corporation under section 355; (5) the receipt of additional consideration under section 356; and (6) the rules regarding the nonrecognition of gain or loss to corporations as well as the treatment of certain distributions under section 361.

[410] Sec. 367(b)(1). Specifically, section 367(b) applies to an exchange described in sections 332, 351, 354, 355, 356 or 361 in connection with which there is no transfer of property described in section 367(a)(1).

[411] The names "Killer B" and "Deadly D" reflect the fact that the original transactions targeted by the guidance were reorganization transactions under sections 368(a)(1)(B) and 368(a)(1)(D), respectively. The guidance applies, however, to a broader range of transactions designed to qualify as tax free reorganizations. In

<u>"Killer B" guidance</u>

Notices 2006-85 and 2007-48 and temporary Treasury regulations subsequently issued under section 367(b)[412] apply to certain triangular reorganizations[413] involving a parent corporation ("parent") and subsidiary corporation ("subsidiary"), at least one of which is foreign. Pursuant to the reorganization, the subsidiary acquires from the parent, in exchange for property, parent stock that is then used by the subsidiary to acquire the stock or assets of a target corporation ("target") (which may be related or unrelated to the parent and the subsidiary before the transaction) in a tax-free reorganization. Prior to the guidance, taxpayers took the position that no gain or loss was recognized on the exchange of parent stock for property under section 1032 and the regulations thereunder, even if the subsidiary acquired the parent stock for cash or a note and had significant previously untaxed earnings and profits. In general, section 1032(a) provides that a corporation will not recognize any gain or loss to the extent it receives any money or other property in exchange for its own stock. To prevent the use of such transactions to inappropriately repatriate previously untaxed earnings without an income inclusion, the regulations provide that the transfer of property by the subsidiary to the parent in exchange for the parent stock shall be treated as a transaction separate from, and occurring immediately before, the triangular reorganization. Therefore, the parent shall not be treated as receiving the property from the subsidiary in exchange for the parent stock and the separate distribution is subject to section 301.[414]

<u>"Deadly D" guidance</u>

Notice 2008-10 and recently issued proposed regulations under section 367(a)(5)[415] address certain transactions designed to repatriate cash or other property from foreign subsidiaries without the recognition of gain or a dividend inclusion, in certain authorized

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addition to issuing guidance on these transactions, temporary regulations were also issued under Treas. Reg. sec. 1.956-1T(e)(6) to address a repatriation transaction where the domestic corporation makes an outbound transfer of its stock or obligations to a CFC in exchange for consideration consisting of CFC stock but primarily cash. Taxpayers had taken the position that the transfer did not trigger a gain or dividend inclusion under Section 1032(a) and that the CFC's ownership of the domestic corporations stock or obligations would not result in section 956 inclusions for the U.S. shareholders of the CFC since the CFC took a zero basis in the transferred stock or obligations pursuant to Section 362(a). The temporary regulation provides that, solely for purposes of Section 956, the basis of the stock or obligation in the hands of the CFC will be equal to its fair market value. As discussed in the Treasury Decision preamble, this temporary regulation was issued under the authority of sections 956(e) and 367(b).

[412] Notice 2006-85, 2006-2 C.B. 677; Notice 2007-48, 2007-1 C.B. 1428; Treas. Reg. sec. 1.367(b)-14T.

[413] A "triangular reorganization" includes a forward triangular merger, a triangular C reorganization, a reverse triangular merger, or a triangular B reorganization under Treas. reg. sec. 1.358-6(b)(2)(i) through (iv), or a reorganization described in section 368(a)(1)(G) and (a)(2)(D).

[414] In general, section 301(c) provides that any applicable distribution will first be treated as a dividend to the extent of earnings and profits, then as a reduction in the adjusted basis of such stock, and any excess will be treated as gain from the sale or exchange or property.

[415] Notice 2008-10, 2008-3 I.R.B. 277; Prop. Treas. Reg. sec. 1.367(a)-7.

reorganizations, by virtue of the application of the basis adjustment rule of section 367(a)(5).[416] The notice describes a fact pattern in which the U.S. parent ("USP"), wholly owns a foreign acquiring corporation ("FA"), and USP's basis in its FA stock is $100. USP also wholly owns U.S. target ("UST"), and USP's basis in its UST stock equals its fair market value of $100. UST owns property with zero tax basis such as self-created intangibles and fully depreciated tangible property. UST sells its property to FA in exchange for $100 cash and, in connection with the transaction, UST liquidates. FA then transfers all of the property acquired from UST to a U.S. Newco ("USN"), a newly formed U.S. domestic corporation, in exchange for 100 percent of the USN stock.

In this and similar fact patterns, taxpayers took the position that the transfer of property by UST to FA was not subject to gain recognition under section 367(a) or (d), because the basis adjustment rule of 367(a)(5) allowed USP to reduce by $100 its basis in the FA stock that it held immediately prior to the transaction.[417] The result of this position was that USP was effectively able to repatriate FA's previously untaxed earnings and profits with little or no U.S. taxation. Notice 2008-10, however, provided that the basis adjustment rule of section 367(a)(5) could not be applied to the stock of FA held by USP immediately prior to the transaction, so that, under the facts within this notice, the transfer of property by UST to FA was subject to the gain recognition provisions of sections 367(a) and (d).

The preamble to the proposed regulations issued under section 367(a)(5) announced that the IRS and Treasury Department were considering whether the gain limitation rule of Section 356(a)(1) should apply in an acquisitive asset reorganization involving a foreign acquiring corporation, considering that section 367(b) is intended to protect against U.S. tax avoidance upon the repatriation of previously untaxed foreign earnings. The preamble requested comments in this regard, including whether any guidance should apply only to cases in which section 356(a)(2) would otherwise apply to the shareholder's receipt of non-qualifying property (i.e., if the exchange has the effect of a distribution of a dividend).[418] Some comments have been received, but no further action has been taken to date.

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[416] Sec. 367(a)(5) generally provides that a transfer of property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange will result in gain recognition to the transferor. It then, however, provides that, in lieu of such gain recognition, regulations will provide for certain basis adjustments if the U.S. transferor is controlled (within the meaning of section 368(c)) by five or fewer domestic corporations.

[417] In taking this position, taxpayers apparently relied upon the legislative history of section 367(a)(5), which provided that the regulations were expected to provide relief from the general rule only if the "U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation." S. Rep. No. 100-455, at 62 (August 3, 1988).

[418] REG-209006-89, 73 Fed. Reg. 49,277 (Aug. 20, 2008) as corrected by REG-209006-89, 73 Fed. Reg. 56,535 (Sept. 29, 2008).

Description of Proposal

The proposal repeals the boot-within-gain limitation of current law in the case of any reorganization transaction if the exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2).

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

Analysis

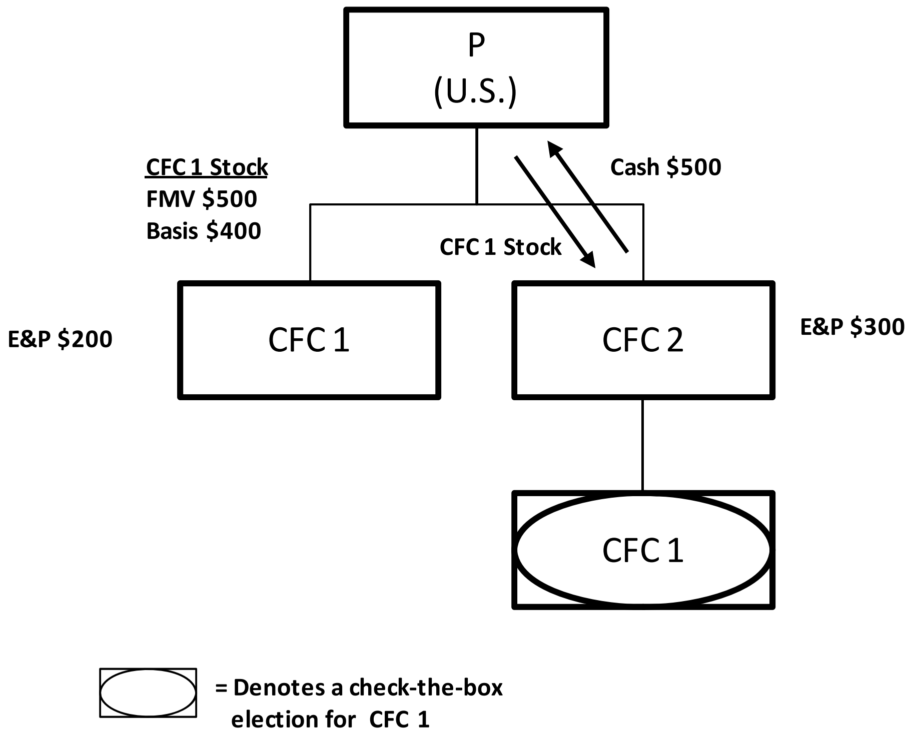
Present law allows significant flexibility to structure distributions of cash or other property to shareholders as dividends in full, or as dividends limited by stock gain, depending upon whether or not the transaction is structured as a reorganization. Furthermore, because of the lack of certainty regarding the earnings and profits that would support dividend treatment in a reorganization (whether those of both the acquiring and acquired corporation or rather only those of the acquired corporation) and because of other uncertain or different rules for reorganization dividends compared to non-reorganization dividends (such as whether there is a dividend to the extent of accumulated earnings and profits only, or also including current earnings and profits for reorganizations, compared to the use of both current and accumulated earnings and profits outside of a reorganization), taxpayers may have significant flexibility as to the extent to which they report a distribution as a dividend on the one hand, or as a recovery of basis and capital gain on the other hand.

The transaction identified by the Administration's proposal

In cross-border reorganizations, the boot-within-gain limitation under section 356(a)(2) can permit U.S. shareholders to repatriate property from their foreign subsidiaries with minimal or no U.S. tax consequences, even if the foreign subsidiaries have sufficient untaxed earnings and profits to treat the repatriated property as a dividend. To the extent the exchanging shareholder's stock in the target corporation has little or no built-in gain at the time of the exchange, the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the acquiring corporation has previously untaxed earnings and profits equal to or greater than the amount of the boot.

The check-the-box regulations have enabled taxpayers more easily to avail themselves of this strategy. Making a check-the-box election to treat the target corporation as an entity disregarded as separate from the owner can convert what would otherwise have been a transfer taxable under section 304(a)(1) into an asset reorganization in which the taxable amount is limited under the boot-within-gain rule of section 356(a).

For example, assume that P, a U.S. domestic corporation, wholly owns CFC 1 and CFC 2. P's shares in CFC 1 have a tax basis of $400 and a FMV of $500. CFC 1 and CFC 2 each have previously untaxed E&P of $200 and $300, respectively. Assume CFC 2 purchases the shares of CFC 1 from P for $500 cash. If a check-the-box election is made to treat CFC 1 as a disregarded entity pursuant to the same plan in which CFC 1 is transferred to CFC 2 and if the other requirements for a reorganization are satisfied,[419] the transaction is treated as a cross-border reorganization to which the boot-within-gain rule applies to limit taxable gain to $100 ($500 FMV less $400 tax basis). If a check-the-box election were not made for CFC 1, or CFC 1 were not otherwise liquidated, section 304(a)(1) would apply to the transaction and the $500 in cash would be treated as a dividend to the extent of the previously untaxed E&P of CFC 2 ($300) and then CFC 1 ($200). The example is illustrated below.



As illustrated above, in a transaction involving commonly-owned corporations, a taxpayer with nonpreviously taxed E&P in its CFCs may, at its option, prevent application of the section 304 requirement of full dividend inclusion to the extent of earnings and profits, and instead invoke the boot-within-gain limitation under section 356(a)(2), by choosing to liquidate the target corporation as part of the transfer. Therefore, eliminating the application of the boot-within-gain limitation in the case of any reorganization in which there is a foreign acquirer and in which the exchange has the effect of distribution of a dividend under section 356(a)(2) is consistent with the principle that previously untaxed earnings and profits of a foreign subsidiary should be subject to U.S. tax upon repatriation. It has been suggested that under present law, any

[419] Reorganization treatment is generally subject to certain requirements, including business purpose, continuity of interest, and continuity of business enterprise.

previously untaxed earnings and profits not deemed distributed by virtue of the boot-within-gain limitation rule may, in certain circumstances, be preserved for future taxation.[420]

Comments provided to Treasury responding to preamble in proposed regulations

The limited comments provided to Treasury in response to its announcement in the preamble to the proposed regulations under section 367(a)(5) raise questions regarding the interaction of section 356(a)(2) with section 367(b) and other provisions. One commentator suggested two alternative views for consideration but only in the context of outbound reorganizations.[421] The first is that, in certain cases, there may be no sufficiently compelling reason of international tax policy to require that the rules of section 356 be displaced by the section 367(b) rules in the context of an outbound asset reorganization. Considerations supporting this view include the fact that the treatment of any boot received in an outbound reorganization (at least in situations where there is an outbound transfer of United States property within the meaning of section 956(c) to a CFC) would need to be coordinated with the rules of section 956. In particular, to the extent that the outbound transfer of United States property would result in subsequent subpart F inclusions under section 951(a)(1)(B),[422] the untaxed earnings and profits of the acquiring CFC would remain subject to U.S. taxation and, accordingly, there may be no compelling need to recharacterize the boot received pursuant to an outbound reorganization as a dividend. The same commentator noted also that, in other situations in which a U.S. parent disposes of its shares of a target corporation (excluding transfers to which section 304 applies), the U.S parent would be entitled to reduce the amount of gain realized on the sale by its basis. The commentator suggested that it is not clear why the presence of an outbound reorganization should displace this concept in favor of taxation of the non-previously taxed earnings of a foreign acquiring corporation. On the other hand, it could be argued that reorganization treatment is an exception to sale treatment, based in part on the concept of continuing ownership, thus justifying different treatment. If the closely held nature of the participants to these types of outbound transactions is a particular concern, the commentator suggested that concern could be addressed through more traditional means (e.g., a finding that the transaction lacked a business purpose).

The second alternative suggested by the same commentator is that, consistent with previously issued guidance under section 367(b) addressing cross-border reorganizations, section

[420] However, as previously noted, there is a lack of clarity under present law whether the limitation on the reduction of earnings and profits under section 312(n)(7) applies in the case of a reorganization. Some have urged that taxpayers may take the position, based on Rev. Rul. 72-327, *supra*, that earnings and profits of the target corporation are reduced by the entire amount of boot in a reorganization, even to the extent not treated as a dividend to the shareholder. See Jasper L. Cummings, Jr., "Corporate E&P and Reorganization Boot," *Tax Notes*, March 29, 2010, p.1635, 1642. To the extent earnings and profits are reduced under this view, they would not be preserved at the target corporation level.

[421] New York State Bar Association Tax Section, Report on Proposed Regulations Issued under Code Sections 367, 1248 and 6038B, 2009 Tax Notes Today 17-18, Jan. 28, 2009, Section IV.J.

[422] Many factors affect an inclusion under section 951(b)(1)(B) including the adjusted basis of U.S. property and the amount of earnings and profits at the CFC.

367(b) should override section 356(a)(1) and require all boot received by a U.S. corporation in the context of an outbound asset reorganization to be subject to current U.S. federal income taxation without regard to the amount of gain realized by target shareholders. More specifically, all boot received in these types of reorganizations could be treated as a severable, pre-reorganization dividend from the foreign acquiring corporation.[423]

Another commentator suggested it would be inappropriate to issue guidance under section 367, because Congress has determined when gain shall be recognized and the amount of such gain constituting a dividend under section 356. This commentator also urged that any previously untaxed earnings and profits not deemed distributed by virtue of the boot-within-gain limitation rule will be preserved for future taxation, and any value attributable to the assets transferred will be maintained, suggesting that there has not been a constructive distribution.[424]

Scope of the proposal

A general premise of the transaction discussed above is that there is a foreign acquiring/transferee corporation that is acquiring the property of a target/transferor corporation (presumably foreign) from its U.S. parent in return for cash or other boot. By acquiring the other corporation's assets from its U.S. parent, the foreign acquirer is able to repatriate cash with little or no U.S. taxation under the boot-within-gain limitation of section 356(a). The proposal, however, also would apply to any other transaction under section 356(a)(1) where the exchange has the effect of a distribution of a dividend, as determined under section 356(a)(2). Thus, the proposal may apply to domestic-to-domestic reorganizations with a foreign shareholder where there may be the potential for withholding tax avoidance. Additionally, the proposal may also apply to domestic-to-domestic reorganizations with a U.S. shareholder, where there may be no withholding tax avoidance intended but where the proposal would increase the amount treated as a dividend. In those circumstances in which the U.S. shareholder is only entitled to a dividends received deduction of less than 100 percent, the result may be an increase in U.S. taxation.[425]

Other technical considerations

Under the proposal, if the boot received by any exchanging shareholder in a reorganization transaction or section 355 distribution, whether domestic or foreign, has the effect of a distribution of a dividend, then the amount treated as a dividend would not be limited to gain on the transaction. However, it is not clear to what extent the dividend treatment would otherwise be consistent with the rules for identifying and measuring nonreorganization dividends.

[423] See, e.g., Treas. Reg. sec. 1.301-1(l) and *Bazley v. Commissioner*, 331 U.S. 737 (1947).

[424] American Institute of Certified Public Accountants, "Comments on the Proposed Regulations on Transfers Subject to Section 367(a)(5) and Certain Cross-Border Asset Reorganizations and Nonrecognition Distributions of the Stock of Certain Foreign Corporations by Domestic Corporations," *2009 Tax Notes Today 100-19*, May 20, 2009, p. 11. But see the view expressed in Jasper L. Cummings, *op. cit., supra,* that corporate earnings may be reduced by the full amount of boot in a reorganization.

[425] Sec. 243(a).

While the proposal is clear in its intent to repeal the boot-within-gain limitation under the aforementioned circumstances, it does not specifically discuss the manner in which the boot will be taxed to the extent it is not subject to the boot-within-gain limitation. As discussed above, section 356(a)(2) requires treating the gain as a dividend to the extent of accumulated earnings and profits with any additional gain being treated as gain from the exchange of property. Since the intent of the proposal is only to repeal the applicability of the boot-within-gain limitation rule and not the treatment of the transaction as one to which sections 354, 355 and 356 apply, one could conclude that section 356(a)(2) would still apply but would treat the entire amount of boot as a dividend to the extent of accumulated earnings and profits not limited by gain. To the extent the boot received exceeds the accumulated earnings and profits and there is any remaining gain realized, such gain would be recognized and treated as gain from the sale or exchange of property. To the extent there is any remaining boot over and above the gain, presumably it would be treated as a tax-free return of basis. Nonetheless, the intended treatment of this additional boot may require further clarification. In addition, consideration might be given to whether it would be desirable to more closely conform the treatment of dividends in reorganization transactions to the treatment of other dividends.

Another issue that may require clarification is the source of the accumulated earnings and profits from which the deemed dividend is generated under section 356(a)(2). As discussed above, conflicting positions exist under present law as to whether the accumulated earnings and profits taken into account should be that of both the transferor and acquiring corporation or, instead, be limited to only that of the transferor corporation. To the extent that the boot-within-gain limitation rule is repealed for such transactions, it will undoubtedly create more scenarios in which the boot amount will exceed the accumulated earnings and profits of either the transferor or acquiring corporation on a stand-alone basis. Therefore, additional guidance may be necessary to determine the source of any deemed dividend under section 356(a)(2). While one of the two approaches discussed above could be pursued, an alternative would be to adopt a rule similar to that which applies to boot received in an intercompany reorganizations within a consolidated group that would otherwise be covered under section 356(a)(2).[426] Such a rule would require that the boot be taken into account after completion of the reorganization which would be based on the combined earnings and profits of the acquiring corporation and target corporation.[427]

In addition, as discussed above, there is a potential lack of clarity under present law whether a reference to "earnings and profits accumulated" includes current earnings and profits

[426] Treas. Reg. sec. 1.1502-13(f).

[427] The proposal does not limit the situations to which it applies only to those of entirely common ownership. Compare Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, pp. 267-68 (2001), recommending a similar proposal but only for certain types of reorganizations. However, the proposal is arguably further simplifying in applying the same rules to all cases in which an exchange has the effect of a dividend. Looking to the earnings and profits of both companies would arguably be consistent with the approach of *Clark v. Commissioner, supra,* which measured the deemed redemption for dividend equivalence on the basis of the stock that would have been owned by a shareholder in the combined corporations after the reorganization.

for the year of the distribution, and whether a limitation on the reduction of earnings and profits under section 312(n)(7) applies in the case of a reorganization distribution that is not treated as a dividend to the shareholder. Additional guidance may be desirable regarding these issues.

Finally, it can be argued that, while the repeal of the boot-within-gain limitation when there is a foreign acquiring corporation will limit the ability of taxpayers to repatriate earnings with little or no tax, it may have other unintended consequences that may be used affirmatively by taxpayers for planning purposes. By way of example, section 304 was enacted to prevent what were deemed to be abusive transactions by taxpayers to convert what would otherwise be dividends into capital gain transactions. Today, taxpayers typically only trigger section 304 when they are affirmatively using it for foreign tax credit and cash repatriation planning purposes. Depending on the manner in which the repeal of the boot-within-gain limitation rule is implemented, it may be expected that similar tax planning opportunities will arise (e.g., if the earnings and profits sourcing and ordering rules differ from those under section 304).

Prior Action

The President's fiscal year 2010 budget proposal contained a similar proposal, but limited that proposal to asset reorganizations involving a foreign acquiring corporation.

F. Reform U.S. International Tax System

1. Defer deduction of interest expense related to deferred income

Present Law

In general

The United States employs a "worldwide" tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income whether derived in the United States or abroad. Income earned in the United States and foreign income earned directly or through a pass-through entity such as a partnership is generally taxed as the income is earned. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until such earnings are repatriated to the United States through a dividend distribution of those earnings to the U.S. person. This ability of U.S. persons to defer income is circumscribed by various regimes intended to restrict or eliminate tax deferral with respect to certain categories of passive or highly mobile income. One of the main anti-deferral regimes is the controlled foreign corporation ("CFC") regime of sections 951 - 965 (referred to generally as "subpart F").

The subpart F regime taxes on a current basis a 10-percent U.S. shareholder's pro rata share of certain earnings of a foreign corporation in which more than 50 percent of the vote or value of a foreign corporation, a CFC, is owned by 10-percent U.S. shareholders. The income to which the subpart F rules apply include foreign personal holding company income (e.g., certain dividends, interest, rents, and royalties) as well as foreign base company sales and services income which include sales and services income from certain related party transactions. Subpart F also generally requires current taxation of certain foreign earnings when a CFC invests its earnings in U.S. property.[428]

The subpart F regime does not apply to a foreign corporation that is not a CFC, even if the foreign corporation has one or more 10-percent U.S. shareholders (commonly referred to as a "10/50 company"). Unless the foreign corporation is taxable under one of the other anti-deferral regimes,[429] the earnings of such a foreign corporation are generally taxable only upon distribution to the U.S. shareholder.

Deductibility of interest expense

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness.[430] An exception to this general rule provides that interest on indebtedness incurred or continued in connection with the purchase or carrying of

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[428] Sec. 956.

[429] One of the other anti-deferral regimes that may apply is the passive foreign investment company regime under sections 1291-1298.

[430] Sec. 163(e)(1).

certain assets that generate tax-exempt interest or dividends is not deductible.[431] In contrast to this exception for interest attributable to tax-exempt income, no similar rules apply to limit the ability of a U.S. taxpayer with foreign operations to deduct its interest expense currently. As a result, a U.S. taxpayer may claim a current deduction for interest expense that it incurs to produce tax-deferred income through a foreign subsidiary.

Allocation and apportionment of interest expense

For the purpose of computing the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. As part of this determination, the taxpayer must allocate and apportion deductions between U.S.-source gross income and certain categories ("baskets") of foreign-source income (e.g., general limitation income and passive limitation income).

In the case of interest expense, the current rules generally are based on the concept that money is fungible, such that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring a specific obligation on which interest is paid. For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets, rather than gross income.[432] An affiliated group in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.[433] As with the rules for filing a consolidated return, the definition of affiliated group for interest allocation purposes generally also excludes foreign corporations.[434] Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply between the domestic and foreign members of a group.

In applying the asset method of interest apportionment, the taxpayer must apportion interest expense between U.S.-source income and the various baskets of foreign-source income

[431] Sec. 265(a)(2), (a)(4).

[432] Sec. 864(e)(1), (e)(2).

[433] Sec. 1504. For consolidation purposes, the term affiliated group is one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations. Generally, an includible corporation is any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

[434] Sec. 864(e)(5). One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations (certain electing domestic corporations that have income from the active conduct of a trade or business in Puerto Rico or another U.S. possession) that are excluded from the consolidated group.

based on the average total value of assets in each grouping for the year. For purposes of determining the value of its assets, the taxpayer may elect to value its assets based on (1) the tax book value method, (2) the alternative tax book value method, or (3) the fair market value method.[435] The taxpayer then determines the average value for the year based on the beginning and end of the year asset values unless such an approach results in a substantial distortion of asset values.[436]

Regardless of the method elected to value the assets, the taxpayer must determine whether the assets generate U.S.-source income, foreign-source income, or both. The Treasury regulations provide that the taxpayer must attribute assets to statutory groupings based on the source and type of income (e.g., manufacturing, sales, services, interest, and dividends) that the assets generate, have generated, or may be reasonably expected to generate.[437] The taxpayer will categorize its assets into one of three categories. The first category of assets is single category assets that generate income that is exclusively within a single statutory or residual group (e.g., general limitation foreign-source income, passive limitation foreign-source income, or U.S.-source income).[438] The second category is composed of multiple category assets that generate income in more than one limitation category (e.g., U.S. manufacturing assets that produce export property that generates partly general limitation foreign-source income and partly U.S.-source income under section 863(b)).[439] The third category is composed of assets without an identifiable yield. These assets either produce no directly identifiable income or contribute equally to the generation of all the income of the taxpayer (e.g., overhead related assets) and are excluded from asset-based apportionment.[440]

After the taxpayer categorizes the assets for purposes of determining whether they generate U.S.-source income or income in one of the baskets of foreign-source income, the taxpayer multiplies the apportionable interest expense by a ratio in which the numerator is foreign assets in each such group and the denominator is total domestic and foreign assets of the taxpayer (hereinafter "the foreign asset ratio"). The resulting interest expense apportioned to each basket of foreign-source income then reduces gross foreign-source income in that basket accordingly for purposes of determining the foreign tax credit limitation in that basket.[441]

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[435] Temp. Treas. Reg. sec. 1.861-9T(g)(1)(ii).

[436] Temp. Treas. Reg. sec. 1.861-9T(g)(2)(i).

[437] Temp. Treas. Reg. sec. 1.861-9T(g)(3).

[438] Temp. Treas. Reg. sec. 1.861-9T(g)(3)(i).

[439] Temp. Treas. Reg. sec. 1.861-9T(g)(3)(ii).

[440] Temp. Treas. Reg. sec. 1.861-9T(g)(3)(iii).

[441] Sec. 904.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes "financial corporations."[442] A financial corporation includes any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity that is not a financial institution.[443] The category of financial corporations also includes bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business.[444]

Instead of treating a financial corporation as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other nonfinancial members of that group, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Worldwide interest allocation

The American Jobs Creation Act of 2004 ("AJCA")[445] modified the interest expense allocation rules described above by providing a one-time election (the "worldwide affiliated group election") under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a "worldwide affiliated group" on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation).[446] If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio that the foreign assets of the worldwide affiliated group bears to

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[442] Temp. Treas. Reg. sec. 1.861-11T(d)(4).

[443] Sec. 864(e)(5)(C); Temp. Treas. Reg. sec. 1.861-11T(d)(4)(ii)(B), (C).

[444] Sec. 864(e)(5)(D); Temp. Treas. Reg. sec. 1.861-11T(d)(4)(ii)(A).

[445] Pub. L. No. 108-357, sec. 401.

[446] The "worldwide affiliated group" includes all corporations in an affiliated group as well as all CFCs that would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group, as modified to include insurance companies) and certain CFCs were attributable to a single corporation.

the total assets of the worldwide affiliated group,[447] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the principles of worldwide interest allocation were applied separately to the foreign members of the group.[448]

Financial institution group election

Similar to the general rules for allocating and apportioning interest expense that allow for treating financial corporations as members of a separate affiliated group, taxpayers are allowed to apply the bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide affiliated group approach. The rules also provide a one-time "financial institution group election" that expands the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the bank group, and (2) all "financial corporations."[449]

Effective date of worldwide interest allocation

The common parent of the domestic affiliated group must make the worldwide affiliated group election or financial institution group election where applicable. It must be made for the first taxable year beginning after December 31, 2020, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group.[450] Once the election is made, it applies to the common parent and all other members of the worldwide affiliated group or to all members of the financial institution

[447] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account. Sec. 864(f)(4).

[448] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[449] A corporation is a "financial corporation" if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons. For these purposes, items of income or gain from a transaction or a series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

[450] As originally enacted under AJCA, the worldwide interest allocation rules were effective for taxable years beginning after December 31, 2008. However, the Housing and Economic Recovery Act of 2008 delayed the implementation of the worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2010. Pub. L. No. 110-289, sec. 3093. The implementation of the worldwide interest allocation rules was further delayed by seven years, until taxable years beginning after December 31, 2017, by the Worker, Homeownership, and Business Assistance Act of 2009. Pub. L. No. 111-92, sec. 15. It has since been delayed until taxable years beginning after December 31, 2020, by the Hiring Incentives to Restore Employment Act of 2010. Pub. L. No. 111-147, sec. 551.

group, as applicable, for the taxable year for which the election is made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

Description of Proposal

The proposal defers the deduction of interest expense that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax. For purposes of the proposal, foreign-source income earned by a taxpayer through a branch is considered currently subject to U.S. tax; thus, the proposal does not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign-source income (for example, royalty income) is similarly treated.

For purposes of the proposal, the amount of a taxpayer's interest expense that is properly allocated and apportioned to foreign-source income is generally determined under current Treasury regulations. The Treasury Department, however, will revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income.

Under the proposal, deferred interest expense is deductible in a subsequent tax year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during that subsequent tax year. Treasury regulations may modify the manner in which a taxpayer can deduct previously deferred interest expense in certain cases.

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

Analysis

Overview

The Administration states that the ability to deduct interest expense attributable to foreign investments while deferring U.S. tax on the income from the investments may cause U.S. businesses to shift their investments and jobs overseas, harming the domestic economy.[451] To address this concern, the proposal eliminates a U.S. person's ability to deduct currently interest expense to the extent that it relates to foreign-source income on which U.S. tax is deferred. The deduction for such interest expense is deferred until the income to which it relates is subject to U.S. tax. By taking this approach, the proposal seeks to match more closely the timing of interest expense deductions with income inclusion.

The analysis that follows discusses: (1) the matching of the timing of interest expense recognition to the taxation of foreign source income sought by this proposal and whether it is appropriate from a policy perspective; (2) the effect of deferral on investment decisions at

[451] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, p. 39, February 2010.

present and the impact this proposal may have on U.S. multinational corporations ("MNCs"); (3) the effect of deferral on residence choice and the impact this proposal may have; (4) the manner in which deferred interest expense will be determined under the proposal, and (5) certain technical considerations.

Matching

As noted above, the proposal seeks to more closely match the timing of interest expense deductions apportioned to foreign-source income with the recognition of such income. In this respect, the proposal is consistent with other Code provisions that require capitalization of costs, with recovery over a period of time to clearly reflect taxable income for a particular taxable year.[452] The Supreme Court recognized this matching concept in *INDOPCO, Inc. v. Commissioner*, noting that "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby, resulting in a more accurate calculation of net income for tax purposes."[453] Additionally, various provisions of the Code require matching of items of a similar character through the delay of otherwise deductible amounts to future years in which income is realized.[454]

By deferring the deduction for interest expense until the foreign-source income to which it relates is currently subject to U.S. taxation, such interest expense deductions arguably would be more closely matched with the revenues of the taxable period to which they are attributable, resulting in a more accurate calculation of taxable income for the taxable period. As discussed above in the present law section, the current rules for interest expense apportionment are based on the concept that money is fungible and require the use of an asset method for the allocation and apportionment of interest expense. Therefore, some may contend that any "matching" would lack the direct correlation of the related income and expense as is the case with other Code provisions that impose a matching requirement.

If the asset method of interest expense apportionment is used as a proxy for a true matching of interest expense to deferred foreign income, one commentator has suggested that the results may be harsh and excessive compared with a true application of the matching principle since the approach would not differentiate between taxpayers with deferred foreign income that are benefiting from deferral (i.e., as a result of the foreign tax rate on the deferred foreign income being lower the U.S. tax rate applicable to those earnings) and those taxpayers that are not benefiting from such deferral (i.e., as a result of their being little or no differential between the

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[452] See, e.g., sec. 263(a) and sec. 263A. See also, Treas. Reg. sec. 1.461-5, which provide rules for the recurring item exception to the economic performance requirement of section 461(h), includes a provision requiring taxpayers to determine whether the accrual of a liability for the taxable year results in a better matching of the liability with the income to which it relates than if the liability were incurred in the taxable year economic performance actually occurs.

[453] *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

[454] Sections 163(d), 465, 469, and 1092 similarly require delay of otherwise deductible amounts to future years in which income is realized. Deborah A. Geier, The Myth of the Matching Principle as a Tax Value, 15 *American Journal of Tax Policy* 17, p. 19 (Spring, 1998).

U.S. and foreign tax rate). To derive a better matching, the commentator suggests limiting the deferred interest expense deduction to the amount of interest expense attributable to deferred foreign income in a jurisdiction multiplied by a percentage equal to the excess of the U.S. statutory tax rate over the applicable foreign tax rate divided by the U.S. statutory tax rate.[455] For example, if the deferred foreign income were in a CFC in Ireland where the statutory rate is 12.5-percent, the percentage of interest expense attributable to deferred foreign income at the Irish CFC that would be deferred would only be 64 percent ((35 percent - 12.5 percent)/35 percent).

While this modified approach to the interest expense deferral proposal may raise significant administrative concern (e.g., determining the applicable tax rates), its consideration has value at the conceptual level. Specifically, it highlights the point that policymakers may want to first consider whether more closely matching the timing of interest expense deductions with foreign income inclusions is the appropriate policy. If it is determined that this is the appropriate policy, consideration should then be given as to what is the best method to accomplish this matching.

Due to the lack of matching relating to the deduction of interest expense attributable to foreign income under present law, a U.S. MNC making an overseas investment may be in a better after-tax position as compared with a U.S. MNC making a similar U.S. domestic investment because of the deduction yielding low (and, in some cases, negative) effective tax rates on foreign income that is deferred for U.S. tax. An analogous situation arises in connection with the allocation of expenses between exempt and nonexempt income in a territorial tax system. This effect of failing to allocate expenses against exempt foreign-source income has been described as facilitating negative effective tax rates for overseas investments, by permitting taxpayers to earn income in low-tax foreign countries while claiming the related deductions in the United States.[456] As a consequence, recent proposals for the adoption of an exemption system in the United States have stressed the increased importance of expense allocation rules and the need to ensure that expenses attributable to the production of exempt foreign income do not inappropriately reduce U.S. tax on domestic source or other nonexempt income.[457]

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[455] Martin A. Sullivan, "Economic Analysis: Obama Chooses a Clumsy Way to Limit Deferral," 123 *Tax Notes* 1163 (June 8, 2009). This approach would synthetically create a result similar to that which could be achieved with a multilateral approach to interest expense allocation where the amount treated as attributable to deferred foreign income of a foreign subsidiary would be deducted on the subsidiary's tax return for foreign tax purposes. See Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," *IBFD, Bulletin for International Taxation*, November 2008, p. 486.

[456] Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in *Fundamental Tax Reform: Issues, Choices and Implications*, edited by John W. Diamond, George R. Zodrow, *2008 MIT Press*, Cambridge (hereafter, Grubert and Altshuler, Corporate Taxes in the World Economy), p. 328. For a numerical illustration, see Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," *IBFD, Bulletin for International Taxation*, November 2008, p. 486.

[457] See, e.g., President's Advisory Panel on Federal Tax Reform, *Proposal to Fix America's Tax System;* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*. But see U.S. Department of the Treasury, *Approaches to Improve Competitiveness (proposing dividend exemption system without allocation of interest expense).*

It is noteworthy that none of the jurisdictions that provide for either the deferral or exemption of active foreign subsidiary income (i.e., the other OECD member countries) have a rule that seeks to achieve a matching similar to this proposal that defers or disallows expenses, such as interest, attributable to deferred or exempt foreign income. As a result, if the proposal is enacted, some may argue the United States would move even further from international norms. Nonetheless, although other jurisdictions may not have expense disallowance regimes in place that specifically defer or disallow interest expense attributable to deferred or exempt foreign income, some do have regimes in place that limit the deductibility of interest attributable to cross-border activity that may approximate an impact similar to that of a regime that would defer or disallow expenses attributable to deferred or exempt foreign income.[458] An example of such a regime is the United Kingdom's recently enacted worldwide debt cap limitation in conjunction with the enactment of a dividend exemption regime. This worldwide dept cap limitation restricts the deductibility of interest and other finance expense on intra-group debt of U.K. companies in cases in which the interest is found to be excessive by reference to such expense in the worldwide group.[459] In addition, rather than formally implementing expense disallowance rules, some jurisdictions with territorial regimes (e.g., France, Germany and Japan) instead, provide less than a full dividend exemption (95 percent rather than 100 percent) as a proxy for taking into account expenses associated with the earning of exempt foreign income.[460]

Although the proposal may make investment in foreign jurisdictions less attractive, to the extent a U.S. MNC undertakes that investment, the U.S. MNC will face the same general barrier to repatriating earnings that it faces under present law —it will be subject to residual U.S. tax on those earnings, subject to possible reduction by a foreign tax credit. Nonetheless, a U.S. MNC may be encouraged to repatriate earnings under the proposal if doing so would allow the taxpayer to take foreign-related interest deductions that previously had been deferred. If, however, the proposal is analyzed in combination with the Administration's proposal to determine the amount of the foreign tax credit on a blended basis (described below), in some circumstances taxpayers may face a greater tax burden on repatriation than they do under present law.[461]

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[458] Remarks of Stephen E. Shay, Deputy Assistant Secretary for International Tax Affairs, U.S. Department of the Treasury International Fiscal Association, 38th Annual Conference of the U.S.A. Branch on February 25, 2010, Observations on U.S. International Tax Policies of Other Nations, 2010 *Tax Notes Today* 38-35.

[459] HR Revenue and Customs, Relief for Interest: Amendments to the "Worldwide Debt Cap Legislation," http://www.hmrc.gov.uk/budget2010/bn07.pdf.

[460] PricewaterhouseCoopers, Worldwide Tax Summaries (France), at http://www.taxsummaries.pwc.com/uk/wwts/wwts.nsf/id/MTHN-6QDJGN?OpenDocument; PricewaterhouseCoopers, Worldwide Tax Summaries (Germany), at http://www.taxsummaries.pwc.com/uk/wwts/wwts.nsf/id/MTHN-6QDHPP?OpenDocument; PricewaterhouseCoopers, Worldwide tax summaries (Japan), at http://www.taxsummaries.pwc.com/uk/wwts/wwts.nsf/id/MTHN-6QDGYU?OpenDocument.

[461] See George K. Yin, "Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers," *Tax Notes*, 118, (Jan. 7, 2008), p. 178. See also Martin A. Sullivan, "Economic Analysis: FTC Proposal Puts Brakes on Earnings Coming Home," *Tax Notes International*, 54, (June 1, 2009), p. 717.

Effect of deferral on investment decisions

Comparison of U.S. MNCs to domestic taxpayers

When evaluating the aspects of present law that permit a U.S. MNC to defer from U.S. taxation active foreign earnings of its foreign subsidiaries, some may believe it is most appropriate to consider the ability of a U.S. MNC to defer the U.S. taxation of income earned in connection with a foreign investment opportunity as compared to that of another U.S. taxpayer that invests only in the United States.[462]

The principal advantage of deferral, when comparing one U.S. taxpayer's foreign investment opportunity to another U.S. taxpayer's domestic investment opportunity, is the ability to retain and invest low-taxed earnings in a foreign subsidiary on a pre-U.S. tax basis. Suppose that a U.S. taxpayer in the 35-percent tax bracket is considering whether to make an investment in an active enterprise in the United States or in an equivalent investment opportunity in a country in which the income tax rate is zero. Assume the U.S. taxpayer chooses to make the investment in the foreign country through a CFC that earns $100 of active income today, and the U.S. taxpayer defers that income for five years by re-investing it in the CFC. Assume further that the CFC can invest the money and earn a 10-percent return per year, and the income earned is not subject to foreign tax and nor does it generate subpart F. The taxpayer would then have $161.05 and pay tax of $56.37 on repatriation, for an after-tax income of $104.68.

If, instead, the U.S. taxpayer pursues the equivalent investment opportunity in the United States, such an investment will not be eligible for deferral. As a result, the taxpayer receives $100 in income today, pays tax of $35, and has only $65 to invest. The taxpayer invests that amount at an after-tax rate of 6.5 percent (this is a 10-percent pre-tax rate less 35 percent tax on the earnings each year). At the end of five years, this taxpayer will have only $89.06. The result is that the foreign investment option to defer the income for five years (and whose deferred income in turn compounded at 10-percent per year) is greater by $15.62 in economic wealth (or 64.9 percent higher) than the domestic investment option that would require the taxpayer to pay tax on the income immediately (and whose after-tax income thus compounded at just 6.5 percent per year). As a result, the foreign investment would be the preferred choice (all else being equal).

The disparity in after-tax effects described above means that there may be foreign investments that earn less on a pre-tax basis than an investment in the United States, but may,

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[462] Analyzing the proposal in this manner may be construed as taking an approach that focuses on promoting economic efficiency or economic welfare through a policy of Capital Export Neutrality ("CEN"). In general, U.S. tax policies associated with CEN focus on minimizing distortions for U.S. taxpayers in determining the location of investment. The goal of CEN is achieved if pre-tax rates of return on investment are the same across jurisdictions (although after-tax returns for investors in different jurisdictions may vary). This policy goal of CEN would generally be achieved if each country adopts a tax system in which its residents are taxed on a worldwide basis without deferral but with an unlimited foreign tax credit. To the extent the expense deferral proposal has the impact of a partial repeal of deferral for some taxpayers, it may be considered as moving in the direction of promoting CEN. Peggy Brewer Richman (Musgrave), "The Taxation of Foreign Investment Income: An Economic Analysis," *The Johns Hopkins Press*, 1963.

nonetheless, result in a greater return on an after-tax basis. Thus, deferral may distort the investment choice when it creates an incentive to choose an overseas investment that yields a lower pre-tax rate of return over a domestic investment that yields a higher pre-tax rate of return. When the lower earning investment is chosen, society as a whole loses the opportunity for greater total income. Economists label such an outcome a social welfare loss from an inefficient allocation of investment.

Generally, the greater the foreign effective marginal tax rate, the closer the rate of return on the investment must be to the rate on the U.S. investment to yield a superior after-tax return. As the foreign tax rate approaches the U.S. tax rate, the distortion approaches zero. However, the longer the residual U.S. income tax is deferred, the less the foreign investment has to earn relative to a U.S.-based investment and the greater the distortion.[463]

While there are many nontax motivations for foreign direct investment, if a taxpayer has made an investment abroad and that investment is in a country with a tax rate lower than that of the United States, this may create a second-order distortion in that it can be to the taxpayer's advantage to attribute as much income as possible to that investment in order to exploit the possible benefit of deferral. This may put pressure on the determination and administration of transfer pricing rules.[464]

By deferring the deduction of interest expense related to tax-deferred foreign income, the proposal would eliminate the reduction of effective tax rates on foreign investment currently available under present law due to the allowance of current deductions for interest expense attributable to such deferred foreign income. To the extent that differentials between effective tax rates on foreign investment and on U.S. investment are reduced, the distortion of the choice of where to invest, the United States or abroad, and the related second-order distortions may be reduced.

If the proposal has the effect of reducing incentives to invest abroad rather than in the United States, it is possible that investment in the United States by U.S. taxpayers may increase.

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[463] An alternative way to think about the trade-off between the deferral period, the foreign tax rate, and the break-even rate of return on a deferred offshore investment is as follows. The longer the period of deferral, the lower the effective residual U.S. tax rate. In fact, permanent deferral would create an effective rate residual tax rate equal to zero. Thus, as deferral increases, the effective total tax rate (U.S. residual tax plus foreign host country tax) that the U.S. taxpayer faces approaches the foreign host country tax rate. Consequently, as deferral increases, the break-even return on a deferred offshore investment declines and approaches the rate of return on the foreign investment net of the foreign host country tax.

[464] Commentators suggest that the issue of addressing improper transfer pricing practices can be similarly problematic in jurisdictions with territorial regimes. J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079 (Dec. 7, 2009) p. 1084. Others suggest that this pressure on transfer pricing can be relieved by ensuring the average corporate tax rate in the United States is more in line with the rest of the world. Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger, "The U.S. International Tax System at a Crossroads," 127 *Tax Notes* 45 (April 5, 2010), page 63.

However, empirical research has not produced definitive conclusions about the effect of foreign direct investment on U.S. labor productivity, wages, and aggregate national income.[465]

Proponents of this proposal may point to the above example as illustrating how present law provides inequitable treatment favoring U.S. MNCs that invest abroad over U.S. domestic taxpayers with only domestic investments. This argument, however, assumes that the foreign investment is profitable and that it is subject to a tax rate that is less than the U.S. tax rate.[466]

Others may challenge the general premise that pre-tax returns on overseas investment options will generally be lower than comparable domestic investment options. Arguably, for U.S. MNCs in relatively mature U.S. markets, there may be more opportunities for higher pre-tax rates of return abroad than in the United States where there may be less competition. Furthermore, for those U.S. MNCs, the only significant investment opportunities may be in foreign markets because comparable domestic markets have been saturated.

In general, the tax analysis described above may be only part of a broader evaluation that U.S. firms engage in when considering whether to invest in the United States or abroad. There

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[465] Robert E. Lipsey, Outward Direct Investment and the U.S. Economy, in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations* (Chicago: University of Chicago Press), 1995. In later research, Lipsey reaches similar conclusions. Robert E. Lipsey, Home and Host Country Effects of FDI, in Robert E. Baldwin and L. Alan Winters (eds.), *Challenges to Globalization* (Chicago: University of Chicago Press) 2004, pp. 333-379. The evidence does, however, suggest that overseas production displaces certain types of domestic production, as the parent firm shifts to more capital intensive and skill intensive domestic production. Lipsey, "Home and Host Country Effects of FDI."

There is no definitive conclusion about the effect of outbound investment on U.S. employment. The same survey concludes, "[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm's home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment . . . ." Lipsey, "Outward Direct Investment and the U.S. Economy", p. 31. One study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. S. Lael Brainard and David A. Riker, "Are U.S. Multinationals Exporting U.S. Jobs?" in David Greenway and Douglas Nelson, eds., *Globalization and Labour Markets*, Elgar, 2001. However, most of the evidence on this subject examines individual industries rather than aggregate economic effects.

The results of a recent study suggest that foreign direct investment may be complementary to and not a substitute for domestic investment. This study was based on firm-level data on domestic and foreign operations of U.S. manufacturers for the period of 1982 - 2004 and found that (1) a 10-percent greater foreign investment is associated with 2.5-percent greater domestic investment; (2) a 10-percent greater foreign employee compensation is associated with 3.7-percent greater domestic employee compensation; and (3) a 10-percent greater sales by foreign affiliates is associated with 6.5-percent greater exports by U.S. parents to their foreign affiliates. Mihir Desai, C. Fritz Foley and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, February 2009.

[466] To the extent the investment generates a taxable loss, the tax benefit of such loss being earned in a foreign subsidiary will, generally, be less than if it had been earned directly by the U.S. taxpayer given that the tax rate in most jurisdictions is lower than in the United States. Furthermore, to the extent the investment is subject to a foreign tax rate that equals or exceeds the U.S. tax rate, there is no tax benefit to deferral assuming the U.S. taxpayer can fully utilize its foreign tax credits to offset the U.S. residual tax on other foreign-source income.

are many reasons that may motivate a U.S.MNC to make an outbound foreign direct investment. Building a plant abroad may be the most cost efficient way for a U.S. MNC to gain access to a foreign market. Trade barriers or transportation costs could make it prohibitively costly to serve the foreign market via direct export from a U.S. location. Foreign direct investment may put the U.S. MNC physically closer to its customers, allowing better customer service and providing a better understanding of the foreign market, which can serve as the basis for improved future marketing of goods and services. A U.S. MNC may make an outbound foreign direct investment to lower operating costs by exploiting less expensive, or more skilled, foreign labor, less expensive access to important raw materials or components from suppliers, or to permit operation in a less burdensome regulatory environment. In addition, foreign direct investment may provide access to foreign-developed technology.

The relative importance of tax and nontax considerations may vary among different kinds of investments. Mobile investments requiring relatively low expenditures on tangible capital or labor, including investments in intellectual property, may be more sensitive to tax rates than investments in plants and other operations that are closely tied to the economic environments in the localities in which those investments are made.

Comparison of U.S. MNC taxpayers to foreign MNCs

Others may believe that the proposal should, instead, be evaluated by comparing the tax treatment of a U.S. MNC considering a foreign investment to that of a foreign MNC evaluating a similar investment in a third country (i.e., not the country in which the foreign investor is tax resident).[467] In making this comparison to foreign MNCs resident in countries that provide for

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[467] Evaluating the proposal from this perspective may be construed as taking an approach that focuses on promoting economic efficiency or economic welfare through the lens of Capital Import Neutrality ("CIN") or Capital Ownership Neutrality ("CON"). The CIN principle focuses on minimizing distortions in the level of savings across jurisdictions; the goal is achieved if the after-tax rate of return on a given investment in a specific location is the same for all investors (although pre-tax rates of return on investments may differ across jurisdictions). Thomas Horst, "A Note on Optimal Taxation of International Investment Income," *Quarterly Journal of Economics,* vol. 41, 2003. The CON principle focuses on minimizing distortions in the ownership of assets with this goal being achieved if productive assets (wherever located) are owned by persons (wherever resident) that have the ability to generate the highest pre-tax returns. Although the goals of both CIN and CON can generally be achieved if each country adopts a territorial tax system (i.e., exempting income earned abroad), the goals of CON can also generally be achieved if every country adopts a full-inclusion worldwide tax system and effectively harmonized rates. With the adoption of territorial systems by many of our trading partners, proponents of CON argue that the only practical way that the United States can achieve CON is to move to a territorial regime as well. Mihir A. Desai and James R. Hines, Jr., "Evaluating International Tax Reform," 56 *National Tax Journal* 487 (September 2003). See also, Mihir Desai and James R. Hines, Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting," 57 *National Tax Journal* 937 (December 2004).

Others contend that the arguments supporting the use of neutrality models such as CEN, CIN, and CON as benchmarks to guide the tax reform process are not satisfactory as they must take place within very simple models. They advocate an alternative approach which is for tax policy makers to consider how the existing tax system creates behavioral distortions among taxpayers (and, to a lesser extent, governments) and whether a given proposal is likely to have success mitigating such distortions. These behavioral distortions include (1) the location of tangible capital, (2) the location of intangible capital, (3) the repatriation decision, (4) financing decisions, (5) income shifting, (6) incentives to lower foreign tax burdens, (7) export decisions, and (8) host government decisions the exemption of active foreign subsidiary income, it is argued that the ability of a U.S. MNC to defer U.S. taxation of active overseas earnings should not be viewed as a competitive advantage. Rather, they argue the ability of a U.S. MNC to defer U.S. taxation of active foreign earnings is a critical factor in allowing the U.S. MNC to compete with a foreign competitor based in a jurisdiction that has a territorial or exemption regime that exempts active foreign subsidiary income from taxation.

Advocates of this perspective note that, of the 30 countries that make up the Organisation for Economic Cooperation and Development (the "OECD"), 25 now have territorial tax systems, including Japan and the United Kingdom which were added to this list in 2009.[468] Thus, only four OECD countries, other than the United States, have worldwide tax systems (Ireland, Korea, Mexico and Poland). Unlike the United States, these four jurisdictions have significantly less outbound foreign direct investment and relatively low statutory corporate tax rates (an unweighted average of 20.9 percent in 2009).[469] They may argue the United States is already an outlier with its present regime of worldwide taxation with deferral for U.S. taxpayers. They maintain that residual U.S. taxation on foreign earnings puts a U.S. MNC in a worse position relative to a foreign competitor based in a country with an exemption regime. Consequently, any proposal that increases U.S. residual taxation only enhances this disadvantage.

Arguably, this proposal may have an impact similar to a partial repeal of deferral for U.S. corporate taxpayers to the extent they have significant U.S. debt. Hence, this may lead some to raise concerns as to how the proposal will affect the competitiveness of U.S. MNCs. Although these competitiveness arguments have been espoused in different ways, the fundamental aspects of the arguments have a common thread focusing on how a proposal to repeal deferral will increase the cost of capital to U.S. MNCs. Consider a U.S. MNC that is subject to tax in the United States at a 35-percent rate on the worldwide income it earns directly, as well as on its active foreign income when repatriated, and a foreign MNC that is resident in a jurisdiction that exempts from taxation active foreign income upon its repatriation. Assume the corporate income tax rate everywhere outside the United States is 25 percent. The income of the foreign MNC from operations in the United States is taxed at the prevailing U.S. corporate income tax rate, 35 percent, as is the income earned by the U.S. MNC. On the other hand, the income earned by the foreign MNC from operations outside the United States is taxed at 25 percent. Under present law, the U.S. MNC arguably may achieve a similar result through deferral.

Absent deferral, however, the income earned by the U.S. MNC from operations in the United States would continue to be taxed at the prevailing U.S. corporate tax rate, generally 35

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regarding the taxation of U.S. companies. Harry Grubert and Roseanne Altshuler, "Corporate Taxes in the World Economy.

[468] "Fact Sheet: U.S. Taxes are Out of Sync with World's Leading Economies," http://www.pace4jobs.org/facts/factsheets_item.php?news_subcategory_id=183.

[469] The statutory corporate income tax rate in each of these jurisdictions is as follows for 2009: (1) Ireland at 12.5 percent; (2) Korea at 24.9 percent; (3) Mexico for 28 percent; and (4) Poland at 19 percent. "Taxation of Corporate and Capital Income Table II.1," http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_37427,00.html#cci.

percent, and the income earned by the U.S. MNC from operations outside the United States would also be taxed at 35 percent. All else being equal, the foreign MNC may have a higher after-tax return than the U.S. corporation. Shareholders, regardless of residence, may view the shares of the foreign MNC as more valuable, because the foreign MNC could pay higher dividends from its after-tax income.[470] As a result, the foreign MNC may have a greater ability to raise capital and that could affect whether the U.S. corporate taxpayer or its foreign competitor wins a competitive bid. If capital investment is shifted from U.S. MNCs to foreign MNCs (e.g., U.S. persons buying shares in foreign-headquartered firms as opposed to U.S.-headquartered firms), some argue this could lead to (1) U.S. MNCs having greater difficulty growing; (2) foreign competitors of U.S. MNCs gaining market share and other business advantages by virtue of being the first to market in certain sectors; and (3) U.S. MNCs becoming more attractive acquisition targets for foreign acquirers to the extent that U.S. MNCs can only capitalize on their global synergies at higher costs due to the U.S. tax on foreign investment.[471]

If the proposal were enacted, in the short run a U.S. MNC would, in general, have two options: (1) continue to defer its overseas active earnings and forgo the portion of the interest expense deduction attributable to the deferred foreign income resulting in an increase in its U.S. tax liability (35 percent multiplied by the forgone current deduction); or (2) repatriate the overseas active earnings and subject such earnings to full U.S. taxation (with offset for a foreign tax credit, as limited) so that it can continue to deduct fully its U.S. interest expense. Perhaps for this reason, some suggest that the proposal should only be considered in the context of broader corporate international tax reform.[472]

Proponents of this proposal may, however, challenge this general assertion that there is a competitiveness problem stemming from the current U.S. international tax regime that would be further exacerbated by this proposal. They may point to the successes of U.S. MNCs in foreign markets and that the lack of empirical data supporting such competitiveness concerns makes these arguments questionable. Moreover, if there are issues of competitiveness in certain U.S. industries, they may challenge the assertion that these issues are primarily attributable to U.S. international tax policy rather than labor cost differentials, product quality differences, regulatory differences, and other nontax factors.[473]

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[470] Joel Slemrod and Reuven Avi-Yonah, "How Should Trade Agreements Deal with Income Tax Issues?" *Tax Law Review,* 55 (2002), p. 533. Slemrod and Avi-Yonah write, "[T]his system is no more efficient than in a domestic context taxing corporations with names beginning with the letters A through K at one rate, while taxing at a higher rate those with names beginning with L through Z (and not allowing name changes)." p. 542.

[471] Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger, "The U.S. International Tax System at a Crossroads," 127 *Tax Notes* 45 (April 5, 2010), pages 61 and 63.

[472] See generally, Amy S. Elliott, "International Tax Reform Won't Proceed Without Larger Tax Reform, Finance Aide Says," 2010 *Tax Notes Today* 44-5 (March 8, 2010). See also Chuck O'Toole, "Levin Says Deferral Can Wait but Targets Tax Havens, Bush Tax Cuts," 2010 *Tax Notes Today* 51-3 (March 17, 2010).

[473] See, e.g., J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079 (Dec. 7, 2009) p. 1086.

Effect of deferral on residence choice

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any state. All other corporations (i.e., those incorporated under the laws of foreign countries) are generally treated as foreign. Only U.S. corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has sufficient nexus in the United States. As a result, present law contains powerful tax incentives for a new firm to opt out of U.S. residence for its top-tier entity.

These tax incentives may lead to an economic distortion that consists of two components. First, an enterprise that in the absence of the prevailing tax policy would have naturally chosen to incorporate in the United States chooses to incorporate elsewhere. This decision creates a "second order" distortion in that, by incorporating outside the United States, the U.S. tax base is not enhanced by tax on the enterprise's future earnings. The impact of this economic distortion on the U.S. tax base may result in higher taxes elsewhere in the economy. Increasing other taxes will increase the economic distortions inherent in those other taxes.

To the extent the proposal increases the effective U.S. tax rate on foreign investment by U.S. firms, firms with U.S. and overseas operations will have an added incentive to conduct their overseas operations not through foreign subsidiaries of U.S. domestic corporations but instead through firms that are owned by foreign persons.[474] If this incentive were strong, it would be possible that over time, the only significant business operations carried out through U.S.-headed firms would be U.S. business operations dealing directly with unrelated U.S. customers. Assuming, however, that anti-inversion rules are effective, existing U.S. firms may be limited in their ability to migrate their existing operations into foreign-headed firms, as the U.S. anti-inversion rules would either prevent the successful migration of these operations or require these U.S. firms to incur significant tax costs to accomplish the migration.[475] Consequently, if the proposal increases the incentive to conduct foreign operations through foreign-headed groups, a possible scenario would be that existing U.S.-headed businesses would remain U.S.-owned (or be acquired by foreign firms) and new foreign business operations would be organized with foreign corporations as the parent entities. Under this scenario, the proposal would impose additional U.S. tax on existing capital investment but, over time, would fail to capture returns from new capital investment in foreign business operations.

Nonetheless, as discussed above in the context of competitiveness, it may be argued that the existing U.S. worldwide tax regime has long created a disincentive to conduct foreign operations through U.S.-headed firms. In spite of this disincentive — which predated and served as the impetus for the enactment in AJCA of the anti-inversion rules — U.S. MNCs have

[474] This analysis assumes that firms will have the ability to conduct foreign operations through firms organized in jurisdictions that do not impose tax on worldwide income. Many countries, including most of the major trading partners of the United States, have adopted territorial taxing regimes.

[475] Sec. 7874.

accounted and still account for a significant portion of cross-border economic activity.[476] A possible explanation is that nontax reasons for organizing global operations under a U.S. parent corporation dominate the tax consequences of such a structure. Regardless, if, in response to the proposal, firms conduct new foreign operations through entities organized in foreign jurisdictions, this may not be so much an argument against the proposal as it may be a suggestion of the malleability of corporate residence based on the U.S. place-of-incorporation rule.[477]

To the extent the proposal has the effect of encouraging new foreign business operations to be conducted through foreign-headed rather than U.S.-headed firms, this effect could be exacerbated if the proposal were enacted in combination with other Administration proposals such as the proposals to determine the foreign tax credit on a blended basis and to tax currently excess returns associated with transfers of intangibles offshore.

Determination of interest expense to be deferred

Analysis of this proposal requires consideration of the methodology to determine the portion of interest attributable to foreign income not currently subject to U.S. tax as well as the pool of earnings that will be considered as not currently subject to U.S. tax. The proposal anticipates using current Treasury regulations, with some modifications, for the purpose of allocation and apportionment of interest expense between currently taxed and noncurrently taxed foreign-source income. As to the pool of earnings considered not currently subject to U.S. tax, the proposal states that it would defer interest expense attributable to a taxpayer's foreign source income that is not currently subject to U.S. tax suggesting that the pool of applicable earnings includes both the earnings of CFCs and 10/50 companies attributable to the taxpayer.

Use of existing Treasury regulations for interest allocation and apportionment

The proposal places a greater emphasis on the location of borrowing and, arguably, would have a disproportionate effect on U.S. MNCs that have relatively high degrees of U.S. borrowing to fund offshore operations, most notably firms in the financial sector. Under present law, a U.S. MNC, all else being equal, can choose to locate its borrowing in the country where the interest expense deduction will produce the largest tax benefit, i.e., the country with the highest tax rate and the fewest restrictions on deductibility. As previously discussed, the fact that a U.S. MNC can claim a current U.S. tax deduction for borrowing to invest in low-taxed

[476] In 2007, nonbank U.S. multinational firms were associated with 49 percent of all U.S. exports of goods and 37 percent of all U.S. imports of goods. Kevin B. Barefoot, Raymond J. Mataloni, Jr., "U.S. Multinational Companies: Operations in the United States and Abroad in 2007," *Survey of Current Business*, August 2009, 89:8, Table 3, page 68. Notwithstanding the continued success of U.S. multinational corporations, a recent study found that the number of U.S. headquartered Fortune Global 500 companies decreased from 36 percent in 2000 to 28 percent in 2009. Tom Neubig, Tiffany Young and Barbara M. Angus, "The changing landscape of headquarters locations and headquarter taxation of Fortune Global 500 companies," http://www.ey.com/Publication/vwLUAssets/The_changing_landscape_of_headquarter_locations_and_headquarter_taxation_of_Fortune_Global_500_companies/$FILE/CM1625.pdf, October 1, 2009.

[477] Sec. 7701(a)(4), (5).

countries increases the after-tax return of those investments above their pre-tax returns, a result that some believe may encourage investments that would not otherwise be made.

The proposal arguably may result in an overcorrection, however, since the worldwide interest allocation rules do not take effect until 2021. As noted above, under present law, interest expense is generally allocated and apportioned based on the taxpayer's ratio of foreign or domestic (as applicable) assets to its worldwide assets, with all members of an affiliated group of corporations (excluding foreign corporations) treated as a single corporation for determining apportionment ratios.[478] As a result, the allocation under present law does not take into account the extent to which foreign members of the group may have borrowed outside the United States to finance their own operations. Instead, the present rules assume that debt incurred by U.S. group members disproportionately funds the operations of foreign subsidiaries and over-allocates interest expense to foreign-source income (an effect commonly referred to as "water's edge fungibility"). The effect of these rules is to understate the taxpayer's foreign tax credit limitation in circumstances where the taxpayer has significant borrowing at its foreign subsidiaries.

As the proposal is silent on the treatment of other provisions of the Code, it is reasonable to conclude that the proposal assumes that the worldwide interest allocation rules would take effect in 2021 as provided in present law. Until such time, however, the over allocation of interest expense to foreign source income under the present "water's edge" allocation rules would result in overstatement of the amount of interest expense subject to deferral − an effect that could be more costly than understatement of the foreign tax credit limitation if the taxpayer's offshore investments are located in relatively low-tax countries.

Opponents of the proposal argue that the magnitude of interest expense that may be properly allocated and apportioned to deferred foreign income under current Treasury regulations could result in the shifting of not only debt but also jobs offshore. To the extent taxpayers can refinance their existing third-party obligations by replacing debt of the U.S. group with new debt at its CFCs, such a strategy may reduce the interest expense deferred under "water's edge" interest apportionment. Furthermore, to the extent a U.S. taxpayer's foreign asset ratio under the interest apportionment rules is expected to be significant, some contend that a taxpayer planning to build a new manufacturing facility may be compelled to finance and build the new facility overseas to avoid the increase to its cost of capital that may otherwise result from its inability to deduct currently the entire interest expense properly attributable to the expansion.[479] The ability and desire to pursue either course of action, however, may also be

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[478] Sec. 864(e)(2); Temp. Treas. Reg. sec. 1.861-9T.

[479] Assume U.S. Parent, a multinational corporation, is planning to expand its manufacturing capacity by building a new plant. U.S. Parent's foreign asset percentage (i.e., U.S. parent's foreign assets as a percentage of worldwide assets) for purposes of apportioning interest expense is 40 percent and is entirely attributable to its investment in its foreign subsidiaries (i.e., no foreign branch assets or other foreign assets generating currently taxable foreign-source income). U.S. Parent is evaluating whether to build the new plant in the United States or to have one of its wholly owned foreign subsidiaries build the plant in the subsidiary's country of incorporation, which has a 25- percent tax rate. The expansion would be financed with $200 million of debt generating $10 million of interest expense annually, and the borrowing will occur in the jurisdiction where the expansion takes place. To the extent U.S. Parent builds the plant in the United States, $4 million of interest expense ($10 million of interest expense multiplied by 40-percent foreign asset ratio) may be deferred depending on the amount of overseas earnings

affected by nontax factors, including increased borrowing costs for foreign borrowing, the availability of cash flow to service such debt, access to qualified employees, proximity to suppliers, and proximity to customers.

The proposal contemplates that current Treasury regulations apply to determine the amount of a taxpayer's interest expense to be allocated and apportioned to foreign-source income. Although not explicitly stated, the proposal would seem to look to present-law regulations to determine the amount of such foreign-source interest expense to be allocated between currently taxed foreign-source income and noncurrently taxed foreign-source income. Applying the current Treasury regulations may be a logical approach given that the methodologies therein are well known and would ensure consistency with the approach taken for sourcing interest expense for purposes of the foreign tax credit limitation.

Nonetheless, the proposal clearly anticipates changes to the existing regulations "as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income." This language suggests that the Administration believes that taxpayers may be engaging in strategies that, in Treasury's view, may under allocate interest expense to foreign-source income for purposes of determining the foreign tax credit limitation.[480] To the extent that this proposal is acted on by Congress in a manner that contemplates use of the existing Treasury regulations, it may be appropriate at such time to perform a broader review of these regulations and modify them as necessary to help ensure they reach a result that is neither over- or under-inclusive when used to determine the interest expense attributable to deferred foreign income.

Inclusion of 10/50 company earnings

The proposal does not distinguish between the deferred foreign income of CFCs and that of 10/50 companies. Some may question the appropriateness of including the earnings of 10/50 companies because the U.S. shareholders of 10/50 companies are, by definition, minority shareholders that may have little control over the decision to repatriate earnings.[481]

U.S. Parent repatriates. If, however, the plant is built in the foreign subsidiary's country of incorporation, the interest expense may be currently deductible in its entirety. To the extent U.S. Parent has significant overseas earnings for which U.S. tax may continue to be deferred, a current deduction at a 25-percent tax rate may be preferable. This example, however, makes the simplifying assumption that the foreign asset ratio would remain unchanged as a result of the U.S. plant expansion, although it actually would be expected to decrease by some amount. To the extent the decrease in the foreign asset ratio is material, it may have a counterbalancing impact on this decision-making process.

[480] One example of such a strategy is the affirmative use of a foreign subsidiary in which the taxpayer owns at least 80-percent of its vote or value where between 50-percent and 80-percent of its gross income is effectively connected with a U.S. trade or business. Taxpayers then take the position that any foreign assets held by this foreign subsidiary are not taken into account for purposes of apportioning the taxpayer's interest expense. Temp. Reg. sec. 1.861-11T(d)(6)(ii).

[481] The results of one study suggest that the participation of U.S. multinationals in joint ventures is sensitive to changes in U.S. tax rules as evidenced by the decline of U.S. investment in noncontrolled foreign affiliates when new limitations were added with respect to the crediting of foreign taxes paid by 10/50 companies.

Technical considerations

The proposal acknowledges that foreign-source income earned by a taxpayer through a branch as well as other directly earned foreign-source income, such as royalty income, is currently subject to U.S. tax. Therefore, the proposal does not apply to interest expense properly allocated and apportioned to such income. Allowing a current deduction for interest expense allocated to income subject to current U.S. taxation is appropriate as it follows the basic policy rationale of the proposal — to match the timing of expense recognition and income inclusion.[482]

The proposal does not explicitly address subapportionment of foreign-source income between foreign-source income that is currently subject to U.S. tax and income that is not currently subject to U.S. tax. However, this subapportionment arguably may be accomplished with only minor modification to the current Treasury regulations. For example, once the taxpayer determines the amount of foreign-source interest expense that is attributable to its investment in includable foreign subsidiaries (i.e., CFCs and 10/50 companies to the extent applicable), such foreign-source interest expense could then be allocated between currently taxed foreign income and deferred foreign income based on a ratio of distributed to undistributed nonpreviously taxed earnings and profits ("E&P").

For purposes of determining the amount of interest expense previously deferred that would be deductible in a subsequent tax year, the proposal states that the amount deductible will be in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during that subsequent year.

The proposal leaves certain technical questions unresolved. For example, the proposal does not address how foreign-source income on which U.S. tax is deferred should be computed. While the universe of foreign-source income on which U.S. tax is deferred for purposes of this proposal would presumably include the nonpreviously taxed earnings of a CFC or 10/50 company, it is unclear whether such nonpreviously taxed earnings would be determined on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately computed company results. Implicit in this question are technical issues such as the treatment of transactions between two foreign subsidiaries for purposes of determining the earnings of each that are includible as foreign subsidiary income not currently subject to tax, and

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Mihir A. Desai and James R. Hines, Jr., "Basket cases: Tax incentives and international joint venture participation by American multinational firms," *Journal of Public Economics*, 71, 1999, 379-402. It is conceivable that the inclusion of 10/50 company earnings within the pool of noncurrently taxed income as proposed could have a similar result.

[482] For a detailed discussion of this issue and other technical concerns related to this proposal, see New York State Bar Association Tax Section, "Report on Administration Proposals Regarding Deferral of Deductions Related to Deferred Foreign Income, Foreign Tax Credit Pooling And Entity Classification Rules," 2009 *Tax Notes Today* 232-75, (December 4, 2009). See also Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady, John D. Bates, "Recent International Tax Proposals Raise Technical Issues," *Tax Notes* (August 3, 2009), pp. 451-70.

the treatment of deficits, including whether the earnings deficit of one foreign subsidiary should offset the positive earnings of other foreign subsidiaries.[483]

Other technical considerations not addressed by the proposal include the need for currency translation rules for determining the nonpreviously taxed CFC and 10/50 corporation earnings on which U.S. tax is deferred, and whether the earnings of entities below the sixth tier that are not included in the section 902 qualified group should be excluded from the computation of foreign-source income on which U.S. tax is deferred.[484]

Tax reporting requirements would also necessarily increase under the proposal. Under present law, annual information reporting relating to E&P is required only with respect to CFCs. Under the proposal, however, the E&P of every CFC and 10/50 company could affect the computation of interest that must be deferred as a result of being attributable to foreign-source income not currently subject to U.S. tax, regardless of the amount of actual or deemed distributions. Thus, it likely will be necessary to provide for additional information reporting with respect to 10/50 companies so that the IRS can verify the accuracy of this computation.

Moreover, although E&P and foreign tax information with respect to 10/50 companies is already required under present law to compute deemed-paid credits, apply the look-through rules to dividends paid by 10/50 companies, and, in many cases, to apportion interest expense in calculating the foreign tax credit limitation,[485] this information can be difficult to obtain if U.S. shareholders do not control the company. Under existing Treasury regulations, a U.S. shareholder must track E&P and foreign tax information for a CFC or 10/50 company beginning only with the first taxable year in which the computation of E&P is significant for U.S. tax

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[483] A related question is the treatment of income that would otherwise be foreign source but that is recharacterized under section 904(f) as U.S.-source income by virtue of the taxpayer having had an "overall foreign loss," or OFL, in an earlier year. If a taxpayer experiences an OFL for a taxable year, the taxpayer is required under section 904(f) to treat as U.S.-source income a portion (generally no more than 50 percent) of any foreign-source income earned in later years, to "recapture" the OFL. The effect is to reduce the taxpayer's foreign tax credit limitation in the subsequent years. The rationale for the recapture is that the OFL has offset U.S.-source income in the year generated, thereby reducing the U.S. tax collected with respect to U.S.-source income in that earlier year. The U.S. fisc would not be made whole when the taxpayer subsequently earned foreign-source income if the U.S. taxes on that income were completely offset by foreign tax credits.

[484] See sec. 902(b)(2)(B)(iii). Under present law, CFCs below the sixth tier of ownership (from the United States) are not considered part of the section 902 qualified group.

[485] The Tax Reform Act of 1986 (Pub. L. No. 99-514) created a separate foreign tax credit limitation category for dividends from 10/50 companies. As enacted, this limitation applied on a corporation-by-corporation basis. The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added a new section 904(d)(4), which required that the foreign tax credit limitation applicable with respect to each 10/50 company be determined based on the underlying E&P from which the 10/50 company paid a dividend, for E&P accumulated in post-2002 taxable years. Any dividends paid during post-2002 years from E&P accumulated in pre-2003 years were, in general, assigned to a single 10/50 dividend basket, rather than to a separate basket for each 10/50 company as in the past. Section 904(d)(4) was then further modified by AJCA (Pub. L. No. 108-357) to extend look-through treatment to post-2002 dividends paid out of pre-2003 E&P.

purposes with respect to its controlling domestic shareholder.[486] Under present law, this computation often is not significant until the controlling domestic shareholder is required to include income in respect of the CFC or 10/50 company. However, as E&P might be a key component in the computation of the interest deductions attributable to foreign-source income on which U.S. tax is deferred, this information could be significant under the proposal for all CFCs and 10/50 companies every tax year.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal. The prior proposal would have applied more broadly to defer deductions for expenses (other than research and experimentation expenditures) of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax.

2. Determine the foreign tax credit on a pooling basis

Present Law

The United States employs a "worldwide" tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Subject to the limitations discussed below, a domestic corporation is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. In addition, a domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or is included in the domestic corporation's income under the provisions of subpart F.[487]

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. Treasury regulations under section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax. In general, a foreign levy is considered a creditable tax if it is substantially equivalent to an income tax under U.S. tax principles. Under the present Treasury regulations, a foreign levy is considered a tax if it is a

[486] See Treas. Reg. sec. 1.964-1(c)(6), which generally provides that a foreign corporation that is a CFC or 10/50 company is not required to make an election to adopt a taxable year or method of accounting until the first taxable year in which the computation of its E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder(s). The regulation provides a list of events that are deemed significant for this purpose, including the shareholder's use of the tax book value method of interest expense apportionment and a distribution (either an actual dividend or a deemed dividend under subpart F) from the foreign corporation to its shareholders with respect to its stock.

[487] Secs. 901, 902, 960. A similar rule applies under section 1293(f) with respect to income that is includible under the PFIC rules.

compulsory payment under the authority of a foreign country to levy taxes and it is not compensation for a specific economic benefit provided by a foreign country.[488]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).[489] This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding 10 taxable years.[490]

The U.S. foreign tax credit limitation provisions include rules that restrict availability of the credit in order to preserve the U.S. tax base. In its most restrictive (or theoretically purest) form, the limitation would function on an item-by-item basis, so that foreign tax imposed on any item of income could offset only the U.S. tax on that item. Historically, however, the limitation rules have operated instead with respect to more administrable groupings of similar items of income.[491]

The present foreign tax credit limitation is generally applied separately for income in two different categories (often referred to as "baskets"), passive basket income and general basket income.[492] Passive basket income generally includes investment income such as dividends, interest, rents, and royalties.[493] General basket income is all income that is not in the passive

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[488] Treas. Reg. sec. 1.901-2(a)(2)(i).

[489] Secs. 901, 904.

[490] Sec. 904(c).

[491] From 1986 through 2006, the foreign tax credit basket rules were significantly more restrictive than the present rules. Prior to 2007, income was assigned to eight separate baskets that were intended to group particular types of income thought to be taxed at similar effective foreign rates. A ninth basket (for dividends from 10/50 corporations) was repealed for post-2002 years. These rules replaced preexisting rules, in effect from 1976 to 1986, under which the foreign tax credit limitation was applied on an overall basis. During various periods prior to 1976, the limitation was applied on a foreign country by foreign country basis (the "per-country limitation"), an overall basis, or a combination of the two. Although the per-country limitation permitted cross-crediting of foreign taxes paid on different types of income from a single country, the effect was nonetheless generally more limited than permitted under present law due to general uniformity of tax bases and tax rates within a country.

[492] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., secs. 901(j), 904(h)(10), 865(h).

[493] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or

category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one basket cannot be used to offset U.S. tax on income in the other basket.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).[494] Passive income is also treated as general basket income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as applicable).[495] Dividends (and subpart F inclusions), interest, rents, and royalties received from a controlled foreign corporation ("CFC") by a U.S. person that owns at least 10 percent of the CFC are assigned to a separate basket by reference to the basket of income out of which the dividend or other payment is made.[496] Dividends received by a 10-percent domestic corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.[497]

Under the present two-basket system, unintended opportunities exist with respect to general basket income of different types and from different countries to maximize one's credit. Thus, tax on income from a high-tax country in one basket can be credited against U.S. tax on income in the same basket derived in a low-tax jurisdiction. Moreover, the general basket encompasses a wide variety of types of active business income that may be taxed at very different effective rates − even within the same country.

Description of Proposal

Under the proposal, a U.S. corporate taxpayer determines its deemed-paid foreign tax credit on a consolidated manner based on the aggregate foreign taxes and earnings and profits ("E&P") of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed-paid foreign tax credit (including lower-tier subsidiaries described in section 902(b)). The deemed-paid foreign tax credit for a taxable year is determined based on the amount of the consolidated E&P of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year. The Secretary is granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

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

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other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

[494] Sec. 904(d)(2)(C), (D).

[495] Sec. 904(d)(2)(F).

[496] Sec. 904(d)(3).

[497] Sec. 904(d)(4).

Analysis

Background

If business income is taxed in the country in which it is derived (the source country), the residence country has two broad options for relieving potential double taxation on the foreign business income of its domestic taxpayers - exempt foreign-source income from home country taxation (an exemption or "territorial" system) or tax foreign-source income but provide a credit against home country taxation for foreign tax paid on that income (a "worldwide" system).[498] The United States has a worldwide system, although the U.S. tax on active foreign earnings derived through foreign subsidiaries is generally deferred until the earnings are repatriated in the form of a dividend distribution. As discussed above, the United States grants a credit (subject to limitations) for foreign taxes paid on foreign earnings, both directly by the domestic taxpayer (for example, on the income of a foreign branch) and indirectly by a foreign subsidiary, to the extent the subsidiary's earnings are distributed.[499]

The basic structure of the U.S. rules reflects several competing considerations. The first, reflected in the general rule of worldwide taxation and the granting of the foreign tax credit, is to ensure that a taxpayer's choice whether to invest in the home country or abroad is not affected by tax considerations. Thus, for instance, if the U.S. tax rules were completely neutral, those rules would not affect a U.S. multinational corporation's decision whether to invest in the United States or in a foreign jurisdiction.[500]

Complete neutrality would require, however, both an unlimited foreign tax credit and full inclusion of all foreign earnings. Assume, for example, that a U.S. multinational corporation has operations in the United States and Country A. For simplicity, assume initially that the corporation carries out its Country A operations directly through a branch rather than through a CFC. The corporation has $1 million of U.S.-source income and $1 million of Country A-source income, for total worldwide income of $2 million. Assume the U.S. tax rate is 35 percent, and the Country A tax rate is 50 percent. The U.S. tentative tax liability, before taking into account the foreign tax credit, is $700,000 (35 percent of $2 million). The Country A tax liability is $500,000 (50 percent of $1 million). An unlimited foreign tax credit would allow the corporation a credit against its tentative U.S. tax liability for the entire $500,000 Country A tax.

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[498] The majority of OECD countries have adopted some variation of an exemption system, though typically in combination with residence-based taxation of passive or highly mobile income.

[499] Secs. 901, 902, 960.

[500] This comparison of neutrality between investments made in the United States to those made in a foreign jurisdiction is a capital export neutrality analysis. This type of analysis is often associated with worldwide taxation of residents and the provision of a foreign tax credit. Two other neutrality models, capital import neutrality and capital ownership neutrality, are other common models used to evaluate international taxation. Under capital import neutrality, investment into a country from all other jurisdictions is taxed in the same manner and could be achieved if all countries had pure exemption systems. Under capital ownership neutrality, tax systems of countries around the world would not distort patterns of ownership of capital investments, and could be achieved if all countries either adopted pure worldwide systems or adopted pure exemption systems. See the discussion above on the Administration's Proposal to "Defer deduction of interest expense related to deferred income."

After this $500,000 credit, the corporation would pay $200,000 in U.S. tax and $500,000 in Country A tax, for a total tax liability of $700,000 on $2 million of worldwide income. As a result of this full foreign tax credit, the U.S. corporation would be subject to tax on its worldwide income at the U.S. 35-percent rate. The corporation would be in the same position it would have been in had its income been entirely U.S-source.

An unlimited foreign tax credit, however, would permit U.S. taxpayers to use the credit to offset U.S. tax on U.S., rather than foreign, source income. In the example above, the U.S. tax on Country A-source income is $350,000 (35 percent of $1 million). An unlimited foreign tax credit for the $500,000 of Country A tax would permit the corporation to eliminate this $350,000 of U.S. tax on Country A-source income and an additional $150,000 of U.S. tax on U.S.-source income. Stated differently, if the United States allowed an unlimited foreign tax credit, other countries could increase their tax rates on U.S. taxpayers' earnings in those countries without increasing those taxpayers' worldwide tax burdens; the only party made worse off would be the U.S. fisc. If, for instance, in the example above Country A raised its tax rate on U.S. corporations investing in Country A to 70 percent, the corporation with $1 million of Country A-source income would pay $700,000 of Country A tax, would eliminate entirely its U.S. tentative tax liability of $700,000, and would have $700,000 of worldwide (Country A) tax liability, the same amount of tax it would be liable for had it invested only in the United States.

The foreign tax credit limitation of present law preserves the U.S. tax base by allowing the foreign tax credit in broad terms to offset only U.S. tax on foreign-source income.[501] Thus, in the preceding example, present law permits the corporation to credit only $350,000 of Country A tax (the U.S. 35-percent tax rate multiplied by the corporation's $1 million of Country A-source income) against its tentative U.S. tax liability of $700,000. After the $350,000 foreign tax credit, the corporation has a worldwide tax liability of $850,000, comprised of $500,000 of Country A tax and $350,000 of U.S. tax. The corporation pays tax on its Country A-source income at the Country A tax rate – $500,000 of tax is 50 percent of $1 million of income – and its overall tax rate on its worldwide income, 42.5 percent, is higher than the 35-percent rate that would have applied if all of its income had been U.S.-source.

Given the absence of an unlimited foreign tax credit, a taxpayer that invests abroad in a high-tax jurisdiction may pay a higher rate of tax on its worldwide income than it would pay if it operated only in the United States. As discussed above, complete neutrality would require not only an unlimited foreign tax credit, but would also require that the foreign business income of U.S. taxpayers be subject to full U.S. taxation as the income is earned. In fact, however, U.S. taxation of foreign business income derived through foreign subsidiaries is delayed until the income is paid to the U.S. parent corporation. A U.S. multinational corporation deriving income in a foreign jurisdiction effectively pays tax on that income at the foreign tax rate if it has the ability to keep the earnings offshore, indefinitely deferring U.S. tax. Thus, a taxpayer that invests abroad in a low-tax jurisdiction may pay a lower rate of tax on its worldwide income than it would pay if it operated only in the United States.

[501] See sec. 904.

The basic construct of the U.S. international tax regime has remained the same since the 1960s. Three relatively new features of the current rules — the explicitly elective (or "check-the-box") entity classification rules promulgated in 1997, the CFC look-through rules enacted in 2006, and the existence of only two foreign tax credit limitation categories effective in 2007 — facilitate the selective repatriation of both earnings and foreign taxes in a manner designed to increase available foreign tax credits after the operation of the foreign tax credit limitation. A simple strategy to reduce taxes by using foreign tax credits might involve, for example, repatriating highly-taxed foreign earnings and using credits generated by this highly-taxed income to offset U.S. tax on other lightly taxed foreign income (so-called "cross-crediting"). More complex credit utilization strategies involve the use of hybrid entities to separate foreign tax credits from the related, deferred foreign-source income, or to create foreign tax credits with respect to income that is not taxable in the United States, to use those credits to shelter other currently taxable foreign-source income. In addition, the availability of hybrid entities has facilitated avoidance of the anti-deferral rules in connection with certain foreign tax minimization strategies that enhance the benefits of deferral. Some commentators have argued that as a result of deferral and selective repatriation strategies, some U.S. taxpayers may have a lower worldwide tax burden than they would have if the United States adopted an exemption system.[502]

Overview

The proposal limits opportunities for selective cross-crediting of foreign subsidiary taxes by establishing mandatory cross-crediting for all foreign subsidiary taxes within the same foreign tax credit basket. In other words, by determining the amount of deemed-paid taxes on an aggregate or blended basis under section 902, the proposal would require that foreign taxes imposed at high rates be used to offset potential U.S. tax liability on lower-taxed foreign earnings, without regard to the timing or source of any particular distribution of foreign earnings.

Specifically, the proposal revises section 902 so that a domestic corporation would determine the amount of foreign taxes that it is deemed to have paid under section 902 with respect to dividends received from a foreign subsidiary (and, correspondingly, under section 960 with respect to subpart F income inclusions) on an aggregate, rather than subsidiary-by-subsidiary, basis. Thus, a U.S. corporation would be required to aggregate its proportionate shares of the foreign taxes and the E&P of all foreign subsidiaries with respect to which the U.S. corporation can claim a deemed-paid foreign tax credit (including lower-tier subsidiaries described in section 902(b)).[503] Under the proposal, the amount of foreign taxes deemed paid in

[502] See, e.g., Rosanne Altshuler and Harry Grubert, "Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," *National Tax Journal*, Vol. LIV, No. 4 (December 2001), p. 16. The American Bar Association Task Force noted that the substantial cross-crediting permitted under existing law is one of several reasons why the U.S. tax rules are more generous to investment in high-tax countries than under an exemption regime; in particular, under an exemption system excess tax credits from high-tax countries cannot be used as credits against tax on other income. American Bar Association, "Report of the Task Force on International Tax Reform," *reprinted* 59 *Tax Lawyer* 649, 775 (2006). ("American Bar Association Task Force Report").

[503] Thus, the proposal would extend to foreign taxes paid by noncontrolled section 902 corporations (i.e., 10/50 corporations), as well as by CFCs.

a taxable year is computed by multiplying the corporation's proportionate share of foreign taxes by the ratio of the corporation's currently taxed income derived from its foreign subsidiaries (dividends and subpart F income inclusions for the current taxable year) and the sum of the U.S. corporation's proportionate shares of the total E&P of each foreign subsidiary. This computation would be performed separately for each foreign tax credit limitation basket.

Once the amount of foreign taxes that the U.S. corporation is deemed to have paid is determined for each basket under the modified rules of section 902, that amount is added to the amount of foreign taxes in that basket for which the U.S. corporation is entitled to claim a direct credit under section 901. The section 904 foreign tax credit limitation (i.e., the amount of pre-credit U.S. tax payable with respect to income in the relevant basket) is then applied to the total amount of such foreign taxes, as under present law.

Under the proposal, therefore, the foreign taxes deemed paid with respect to dividends and subpart F income inclusions reflect the weighted average of the foreign tax rates paid by each foreign subsidiary. Thus, a dividend paid to a U.S. parent by a subsidiary organized in a low-tax jurisdiction would typically carry deemed-paid foreign taxes in excess of the foreign taxes actually paid to that low-tax jurisdiction with respect to the distributed earnings. In contrast, a dividend paid to a U.S. parent by a subsidiary organized in a high-tax jurisdiction would typically carry deemed-paid foreign taxes in an amount that is less than the foreign taxes actually paid to that high-tax jurisdiction with respect to those earnings.

To illustrate this effect, consider a domestic corporation, Parent Co., that owns 100 percent of the shares of each of Alpha Co. and Bravo Co., CFCs organized in countries A and B, respectively. Alpha Co. has pre-tax earnings of $1,000 in the general basket, pays foreign taxes of $125 (a 12.5-percent tax rate), and has net E&P of $875. Bravo Co. also has pre-tax earnings of $1,000 in the general basket, but pays foreign taxes of $410 (a 41-percent tax rate) and has net E&P of $590. The aggregate amount of net E&P of Alpha Co. and Bravo Co. is $1,465 ($875 + $590),[504] and the aggregate amount of foreign taxes paid is $535 ($125 + $410).

Under present law, if Alpha Co. distributes $500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid would be $71 ($125 x ($500/$875), but if the $500 distribution was made instead from Bravo Co., Parent Co. would be deemed to have paid $347 ($410 x $500/590). Under the proposal, Parent Co.'s decision regarding whether the $500 is remitted from Alpha Co. or Bravo Co. would not be influenced by the amount of foreign tax credits, as a $500 distribution from either Alpha Co. or Bravo Co. would result in a deemed-paid foreign tax amount to Parent Co. of $183 ($535 x ($500/$1,465)).[505]

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[504] Undistributed earnings are reduced by the amount of foreign income taxes paid or accrued, whether or not those taxes are creditable. See Treas. Reg. sec. 1.902-1(a)(9)(iii) (post-1986 undistributed earnings are reduced for purposes of the analogous corporation-by-corporation computation under present law).

[505] The blended effective tax rate on Parent Co.'s share of the aggregate earnings of Alpha Co. and Bravo Co. is 26.8 percent ($535/($1,000 + $1,000)). Parent Co.'s deemed-paid foreign taxes of $183 on distributed earnings of $500 reflects that blended rate after the section 78 gross-up amount ($183), i.e., $183/($500 + $183) = 26.8 percent.

Cross-crediting through selective repatriation

As described earlier, the present foreign tax credit limitation rules permit cross-crediting of foreign tax that is imposed at a rate higher than the applicable U.S. tax rate against residual U.S. tax on income in the same limitation basket that is subject to foreign tax at a rate lower than the U.S. rate. Historically, the U.S. foreign tax credit rules have restricted cross-crediting to varying degrees. The per-country limitation that applied in various forms prior to 1976, and the nine-basket regime that applied from 1986 through 2006, represented fairly stringent, although conceptually different, limitations on cross-crediting. The reduction in the number of baskets to two (passive and general) by AJCA increased the extent to which cross-crediting is feasible between income of different types and from different sources.[506] Consequently, planning to maximize the use of foreign tax credits has assumed increasing importance in determining whether and when to repatriate foreign earnings.

Under present law, foreign tax credit planning typically involves selective repatriation of particular pools of foreign earnings, e.g., timing the repatriation of high-taxed income to coincide with the inclusion of low-taxed income. For example, excess foreign taxes (i.e., foreign taxes in excess of the U.S. 35-percent corporate rate), such as those arising in connection with the receipt of dividends from a foreign subsidiary in a high-tax jurisdiction, may be used to offset U.S. tax on royalties received for the use of intangible property in a low-tax jurisdiction. According to one study, even before AJCA took effect, almost two-thirds of all foreign-source royalties were sheltered by excess foreign tax credits in 2000, meaning that no residual U.S. tax was due.[507] In addition, multinational corporations engage in a variety of techniques that utilize the entity classification rules to direct the source of foreign earnings, the time at which the earnings are subject to U.S. tax, or the amount of associated foreign tax.

The proposal limits the benefits of selective repatriation strategies by disassociating the amount of deemed-paid foreign taxes under section 902 from the actual amount of foreign tax paid on distributed earnings. Under the proposal, earnings distributed by a foreign subsidiary in any jurisdiction carries with them foreign taxes deemed paid at the same average effective rate. In effect, the proposal requires universal cross-crediting of foreign taxes paid by foreign subsidiaries, across both countries and income types (within each basket) and without regard to the timing of repatriation; taxpayers would no longer be able to selectively cross-credit.

The proposal represents a significant departure from traditional efforts to tailor limitation categories to be administrable yet sufficiently precise to approximate the results of an item-by-item limitation.[508] Instead, the proposal adopts a precisely opposite aggregation approach in an

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[506] The American Bar Association Task Force Report described the rules of present law as allowing "virtually unlimited cross-crediting, except with passive income." American Bar Association, "Report of the Task Force on International Tax Reform," *reprinted* 59 Tax Lawyer 649, 775 (2006).

[507] Harry Grubert and Rosanne Altshuler, "*Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*," 11 (2006) Departmental Working Paper No. 200626, Department of Economics, Rutgers University, available at <ftp://snde.rutgers.edu/Rutgers/wp/2006-26.pdf>.

[508] The American Bar Association Task Force Report recommended either reverting to a per-country foreign tax credit limitation or grouping together countries with similar tax bases or effective tax rates. American

effort to make taxpayers indifferent (from a foreign tax credit perspective) as to the source from which foreign subsidiary earnings are repatriated and the time at which foreign subsidiary taxes are eligible to be claimed as a credit.

The proposal would not, however, eliminate opportunities for foreign tax credit planning. Because the proposal applies only for determining deemed-paid taxes creditable under section 902, incentives would exist for structural planning to manage the effective tax rate of income earned through subsidiaries. Such planning could be designed to remove high-taxed foreign earnings from the blending regime, e.g., by converting foreign subsidiaries located in high-tax jurisdictions into branches or partnerships, so that foreign taxes associated with those earnings would be considered directly paid taxes under section 901 rather than section 902. Alternatively, taxpayers could plan to remove low-taxed earnings from the blending regime, e.g., by placing low-taxed subsidiaries below the sixth-tier foreign corporations described in section 902(b)(2).

Under present law, sections 902 and 78 establish parity between the treatment of foreign taxes paid with respect to branch income and those paid with respect to income earned in foreign subsidiaries. Foreign-source income earned through a foreign branch is fully includible by a U.S. corporation, without reduction for foreign taxes paid on that income, and the full pre-tax amount is reflected in the section 904 limitation fraction. The amount of foreign-source income earned through a foreign subsidiary that can be distributed as a dividend for U.S. tax purposes (and thus can actually be received by a U.S. corporation) will necessarily be an after-tax amount, i.e., earnings reduced by the amount of the foreign taxes paid by the subsidiary on those earnings.[509] Section 78 requires, however, that a U.S. corporation claiming a foreign tax credit under section 902 include, as additional dividend income, an amount equal to the foreign taxes that it is deemed to have paid under section 902 (or section 960). This section 78 "gross-up" ensures that the full amount of the earnings on which the foreign taxes were paid is reflected in the calculation of the section 904 limitation. The result parallels the treatment of income earned through a branch, which is fully includible in income without reduction for foreign taxes (assuming that the taxpayer elects to claim a credit rather than a deduction for the foreign taxes paid).

Under the proposal, however, foreign taxes paid by a foreign branch would be fully available for credit, subject only to the section 904 limitations applicable to general basket income and passive basket income, while foreign taxes paid by a foreign subsidiary would be creditable only to the extent of the average effective foreign tax rate (determined by taking into account all foreign subsidiaries). The section 78 gross-up mechanism provides parity in the computation of taxable income earned through a branch and through a subsidiary, but does not address this timing disparity. Consequently, U.S. corporate taxpayers may have an incentive to earn high-taxed foreign-source income through a branch rather than a subsidiary. The result may be to encourage the conversion of existing subsidiaries into branch form, or the establishment of

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Bar Association, "Report of the Task Force on International Tax Reform," *reprinted* 59 Tax Lawyer 649, 775 (2006).

[509] The amount that can be paid out as a distribution is determined under foreign law, but the amount of the distribution that is a dividend is determined under U.S. law.

new branches rather than new subsidiaries in countries with relatively high foreign tax rates. To the extent that a U.S. corporation is able to place high-taxed foreign-source income in branches, it could be expected that any foreign-source income remaining in its foreign subsidiaries will be subject to a relatively lower foreign tax rate. Over time, the foreign taxes associated with undistributed foreign subsidiary income could diminish, increasing the expected U.S. tax liability associated with repatriation of that income and, thus, the disincentive to repatriation. Such an effect should be considered in conjunction with the Administration's Proposal to "Defer Deduction of Interest Expense Related to Deferred Income," which is intended to encourage repatriation of foreign earnings.

Technical and administrative considerations

The proposal requires resolution of a number of additional technical and administrative questions, either by statute or by regulation. Most importantly, it would be necessary to develop rules for allocating subsidiary earnings and foreign taxes proportionally among multiple shareholders (direct and indirect), including in situations in which shareholders' proportionate interests change as a result of acquisitions, dispositions, dilutions, mergers, and other corporate events. Addressing these events would likely require the establishment of shareholder-level accounts to which the earnings and foreign taxes of a foreign subsidiary would be allocated annually, based on the shareholder's proportionate ownership of the subsidiary during the year. The rules would need to consider the treatment of the accounts upon a change in ownership of the shares.[510]

Another significant consideration is the manner in which the pools of foreign subsidiary earnings would be determined: whether on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately computed company results. Implicit in this question are technical considerations such as: (1) the treatment of transactions between two foreign subsidiaries for purposes of determining the earnings of each that are includible in the aggregate pool of earnings; (2) the treatment of deficits, including whether the earnings deficit of one foreign subsidiary should offset the positive earnings of other foreign subsidiaries; (3) ordering rules for determining the extent to which an earnings deficit in one basket should reduce positive earnings in another basket of the same foreign subsidiary or other foreign subsidiaries; and (4) whether the amount and separate limitation character of dividends and subpart F inclusions should be determined by reference to the aggregate blended E&P pool or on a separate-entity basis.

Additional technical considerations include: (1) integration of the proposal with the rules of section 905(c) addressing foreign tax redeterminations; (2) currency translation rules for determining the amounts included in the blended pools of foreign taxes and foreign earnings, and

[510] Under section 1248, gain recognized on a transfer of shares of a CFC by a 10-percent U.S. shareholder is generally treated as a dividend, to the extent of the accumulated earnings of the CFC attributable to those shares during the shareholder's holding period. Under section 902, as modified by the proposal, such a dividend would carry with it a proportional amount of the foreign taxes in the shareholder's account. Any earnings and foreign taxes remaining in the account, e.g., as a result of the application of the gain limitation to the amount treated as a dividend under section 1248, could be either added to the new shareholder's earnings and foreign tax accounts or eliminated.

for translating into U.S. dollars and computing exchange gain or loss on distributions from those blended pools; (3) treatment of foreign earnings and foreign taxes in foreign subsidiaries below the sixth-tier that are not included in the section 902 qualified group;[511] (4) the interaction between the rules for determining the taxable distribution under sections 301 and 302, under which E&P is determined on an entity-by-entity basis, and the proposal's determination of the available foreign tax credit, under which E&P is determined on an aggregate basis; and (5) whether the available foreign tax credit for a particular taxable year (before application of the section 904 limitation) is determined on the basis of a single, carryforward calculation.

Tax reporting requirements would also necessarily increase under the proposal. Under present law, annual information reporting relating to E&P and foreign taxes is required only with respect to CFCs. Under the proposal, however, every foreign subsidiary's E&P and foreign taxes would affect the current year section 902 credit of the U.S. parent corporation, regardless of the amount of actual or deemed distributions from that subsidiary. Thus, it will likely be necessary to provide for additional information reporting with respect to 10/50 companies so that the IRS can verify the amount of section 902 credits claimed on taxpayers' returns.

Moreover, although E&P and foreign tax information with respect to 10/50 companies is required under present law to compute deemed-paid credits, apply the look-through rules to dividends paid by 10/50 companies, and, in many cases, to apportion interest expense in calculating the foreign tax credit limitation,[512] this information can be difficult to obtain if U.S. shareholders do not control the company. Under existing Treasury regulations, a U.S. shareholder must maintain E&P and foreign tax information for a CFC or 10/50 company beginning only with the first taxable year in which the computation of E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder.[513] Under present law, this information often is not significant until the controlling domestic shareholder is required to include income in respect of the CFC or 10/50 company. Under the proposal, however, this information would likely be significant for all CFCs and 10/50 companies every taxable year.

[511] See sec. 902(b)(2)(B)(iii). Under present law, CFCs below the sixth tier of ownership (from the United States) are not considered part of the section 902 qualified group.

[512] The Tax Reform Act of 1986 (Pub. L. No. 99-514) created a separate foreign tax credit limitation category for dividends from each 10/50 company. As enacted, this limitation applied on a corporation-by-corporation basis. The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added a new section 904(d)(4), which required that the foreign tax credit limitation applicable to dividends from each 10/50 company be determined based on the underlying E&P from which the 10/50 company paid a dividend (i.e., on a look-through basis), for E&P accumulated in post-2002 taxable years. Any dividends paid during post-2002 years from E&P accumulated in pre-2003 years were, in general, assigned to a single 10/50 dividend basket, rather than to a separate basket for each 10/50 company as in the past. Section 904(d)(4) was then further modified by AJCA (Pub. L. No. 108-357) to extend look-through treatment to dividends paid in post-2002 taxable years, without regard to when the distributed earnings were accumulated.

[513] Treas. Reg. sec. 1.964-1(c)(6). The regulation provides a list of events that are deemed significant for this purpose, including the shareholder's use of the tax book value method of interest expense apportionment and a distribution (either an actual dividend or a deemed dividend under subpart F) from the foreign corporation to its shareholders with respect to its stock.

Transition considerations

The proposal does not provide for a transition rule, with the result that all foreign taxes and all earnings of foreign subsidiaries, including amounts attributable to periods prior to the enactment of the proposal, may be subject to the blending rule. This approach would be simpler than a phased-in effective date rule because separate tracking of pre- and post-effective date earnings and taxes pools would not be required. However, complex rules would be required for merging earnings and taxes accounts of foreign subsidiaries acquired by U.S. shareholders and subject to the pooling rules on different dates, or that presently maintain layered earnings and taxes accounts resulting from pre-effective date merger and acquisition activity.

An alternative approach, similar to that adopted with respect to the section 902 amendments made by the Tax Reform Act of 1986[514] (establishing the multi-year pooling rules), would be to establish separate pools of pre- and post-enactment date foreign taxes and earnings. This approach would require ongoing maintenance of separate pre- and post-effective date earnings and foreign tax accounts and, by implication, two sets of foreign tax credit rules. It would also require a dividend ordering rule for determining the amount of any dividend paid from pre-effective date earnings versus the amount paid from post-effective date earnings.[515]

Treaty considerations

It is conceivable that U.S. income tax treaty partners and commentators may argue that the proposal is inconsistent with the U.S. obligations under the relief from double taxation provisions of its income tax treaties. Such provisions generally require the United States to relieve double taxation by allowing its citizens and residents a credit against U.S. income tax liability for income tax paid or accrued directly by those citizens or residents to the other treaty country. Typical U.S. tax treaties also require the United States to allow a domestic corporation that owns at least 10 percent of the voting stock of a corporation resident in the other treaty country that receives dividends from the other corporation a credit (an "indirect credit") against U.S. tax for the tax that the other corporation pays to the other treaty country with respect to the profits out of which such dividends are paid.[516]

As described earlier, in situations in which the domestic corporation is a 10-percent-or-greater shareholder in two or more foreign corporations located in different countries with different effective tax rates, the amount of foreign taxes that a domestic corporation would be deemed to have paid under the proposal with respect to distributed earnings of a foreign

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[514] Pub. L. No. 99-514.

[515] See, e.g., Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," *National Tax Journal,* 54, p. 784, suggesting this approach in connection with transitioning to an exemption system and noting that precedent is found in the rules applicable to C corporations that elect subchapter S status and in the transition rules adopted in 1986 in connection with the modifications to the foreign tax credit limitation rules.

[516] U.S. Treasury Department, United States Model Income Tax Convention of November 15, 2006, Article 23 (Relief from Double Taxation). Most U.S. income tax treaties include essentially the same language.

subsidiary may not correspond directly to the amount of taxes paid by the subsidiary on those earnings. Rather, the amount of taxes deemed paid would reflect a weighted average of the effective tax rates paid by each of those subsidiaries. Thus, in the case of a foreign subsidiary located in a country with a relatively high tax rate, the amount of taxes deemed paid by the U.S. corporation could be lower than the amount actually paid by the subsidiary on the distributed earnings. Conversely, in the case of a foreign subsidiary located in a country with a relatively low tax rate, the amount of taxes deemed paid by the U.S. corporation could be higher than the amount actually paid by the subsidiary on the distributed earnings. Either case raises a question as to whether the foreign tax credit allowed as a result of the proposal is strictly consistent with a treaty's relief from double tax requirement that credit be allowed for "the" income tax paid to the treaty country in question. In particular, a treaty country whose income tax rate is relatively high may argue that the disassociation of the deemed-paid tax amount from the amount of tax actually paid or accrued by the subsidiary to that treaty country on the distributed earnings is a violation of the treaty.

In cases in which potential technical arguments could allege the existence of a conflict between U.S. domestic law and U.S. treaties, there is precedent for providing an express treaty override to forestall litigation.[517] In the absence of an express treaty override, the legislation would be expected to take precedence over an income tax treaty based on the "last-in-time" principle if the proposal were not consistent with the treaty's relief from double taxation requirements.[518]

The proposal may be viewed as consistent with the U.S. treaty obligations because it does not deny a foreign tax credit for the full amount of foreign taxes paid on earnings distributed from higher-tax countries. Rather, in the case of foreign taxes paid at a relatively high rate (i.e., a rate higher than the weighted average rate paid by all of the domestic corporation's subsidiaries), the effect of the proposal is to defer the availability of the full credit until all earnings, in the aggregate, have been distributed to the domestic corporation by its foreign subsidiaries. In this respect, the proposal is somewhat similar to the foreign tax credit limitation rules of section 904, which are expressly contemplated by U.S. income tax treaties. The purpose of the section 904 rules is to limit the extent to which foreign taxes may be credited in a particular year to ensure that U.S. tax on U.S.-source income is not offset by direct and deemed-paid credits, as well as to mitigate cross-crediting across different types of foreign-source income. The rules do not deny a foreign tax credit to the extent that taxes in excess of the current year limitation can be used in a carryforward or carryback year.

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[517] See, e.g., Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647), Section 1012(aa)(2)(A). This provision expressly resolved several such conflicts that arose from the Tax Reform Act of 1986 (P.L. 99-514), including a treaty override provision with respect to the section 904(d) limitation categories. See also Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987* (H.R. 2636 and S. 1350) (JCS 15-87), June 15, 1987, p. 320. The Joint Committee staff noted that prior legislation, such as the Revenue Act of 1962 (Pub. L. No. 87-834), had expressly provided an override of prior treaty obligations to forestall any possible litigation.

[518] Sec. 7852(d)(1).

On the other hand, the proposal would function differently from the section 904 limitation in the sense that section 904 restricts a taxpayer's ability to credit one country's tax against U.S. income tax on *other income* (i.e., income other than the income on which that tax was paid). In contrast, the proposal would limit a domestic corporation's ability to credit foreign tax against the U.S. income tax imposed on the *same income* on which the foreign tax was paid, which some treaty partners may view as a conflict with the U.S. treaty obligations.

The effect of the proposal on a particular domestic corporation would vary depending on the locations of its foreign subsidiaries, their relative sizes, and the extent to which the domestic corporation chooses to repatriate each subsidiary's earnings.

Other considerations

Some argue that this proposal to determine the foreign tax credit on a pooling basis will only exacerbate the competitive disadvantages they view as inherent in the U.S. international tax system. They argue that the United States is an outlier as one of the only OECD countries that has retained a worldwide tax regime.[519] They argue that under present law, the existence of a residual U.S. tax liability, even if deferred, reduces after-tax returns from offshore investments below that obtained by foreign-based MNCs. The lower after-tax return places U.S. MNCs at a competitive disadvantage in developing or expanding foreign markets. To the extent that the proposal increases the tax rate on foreign earnings, a U.S. MNC's residual tax liability on active foreign business earnings increases, further reducing after tax returns to investment abroad.

Others challenge the general assertion that there is a competitive disadvantage inherent in the U.S. international tax system. They argue that that there is no empirical evidence of such a competitive disadvantage and that such claims are questionable given the success of many U.S. businesses overseas. Moreover, if there are issues of competitiveness in certain U.S. industries, they may challenge the assertion that the issues are attributable to the U.S. international tax system rather than labor cost differentials, product quality differences, regulatory differences, and other nontax factors.[520] Additionally, proponents of the proposal argue that the U.S. international tax system provides a competitive advantage to U.S. MNCs over their U.S. competitors by creating an incentive to move jobs and business operations overseas.[521] See the discussion above on the Administration's Proposal to "Defer deduction of interest expense related to deferred income," for a more detailed discussion of the arguments.

[519] Only four other OECD countries, Ireland, Korea, Mexico, and Poland, currently have worldwide tax system. These four jurisdictions have significantly less outbound foreign direct investment and relatively lower statutory corporate tax rates as compared to the United States.

[520] J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079 (Dec. 7, 2009) p.1086.

[521] Alison Bennett, "Support for Stand-Alone Use of International Budget Provisions Continues, Sperling Says," *The Bureau of National Affairs, Inc. Daily Tax Report,* April 22, 2010, 76 DTR G-6.

Prior Action

The President's fiscal year 2010 budget contained a substantially similar provision.

3. Prevent splitting of foreign income and foreign taxes

A provision substantially similar to the President's fiscal year 2011 budget proposal was included in H.R. 1586, which was signed into law by the President on August 10, 2010.

4. Tax currently excess returns associated with transfers of intangibles offshore

Present Law and Background

In general

The United States employs a "worldwide" tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Subject to certain limitations, a domestic corporation is allowed to claim a credit against its U.S. income tax liability for foreign taxes paid. The foreign tax credit provides relief from double taxation.

Income earned directly or through a pass-through entity (such as a partnership) is taxed on a current basis. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until such earnings are repatriated to the United States through a dividend distribution of those earnings to the U.S. person. This ability of U.S. persons to defer income is circumscribed by various regimes intended to restrict or eliminate tax deferral with respect to certain categories of passive or highly mobile income. One of the main antideferral regimes is the controlled foreign corporation ("CFC") rules of subpart F,[522] which limits tax deferral with respect to certain categories of passive or highly mobile income.

The United States also has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a foreign controlled party through inappropriate pricing of related party transactions. The statutory authority for those rules is found in section 482, and the principal measure by which that authority is exercised is the arm's-length standard.[523]

Foreign tax credit

A domestic corporation is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays, subject to certain limitations. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-

[522] See secs. 951-965. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended.

[523] Treas. Reg. sec. 1.482-1.

paid" credit for foreign income taxes paid or accrued by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or included in the domestic corporation's income under subpart F.[524]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability otherwise due on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[525]

Historically, the U.S. foreign tax credit limitation provisions have included various alternative approaches to limiting cross-crediting in order to preserve the U.S. tax base.[526] Presently, the foreign tax credit limitation regime applies separately for income in two different categories (referred to as "baskets"), passive category income and general category income.[527] Passive category income generally includes (with certain exceptions, including when income is earned as part of an active business) investment income such as dividends, interest, rents, and royalties.[528] General category income is all income that is not in the passive income category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one category cannot be used to offset U.S. tax on income in the other category.

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524 Secs. 901, 902, and 960. A similar rule applies under section 1293(f) with respect to income that is includible under the passive foreign investment corporations ("PFIC") rules.

525 Secs. 901 and 904.

526 From 1921 through 1962, there were no "baskets." In 1962, a separate basket was added for certain interest income. Revenue Act of 1962, Pub. L. No. 87-834, Sec. 10. Separate baskets for certain foreign-source oil related income were added in 1975. Tax Reduction Act of 1975, Pub. L. No. 94-12, Sec. 601(a). An elaborate basketing system was added by the Tax Reform Act of 1986, pursuant to which nine separate baskets were provided for items such as passive income, financial service income, and shipping income. Pub. L. No. 99-514, Sec. 1201. In addition to separate basketing by income category, from 1932 until 1954, the foreign tax credit was subject to the lesser of an overall limitation or a per-country limitation. 1932 Revenue Act, Pub. L. No. 72-154, Sec. 131(b)(1). From 1954 until 1960, the credit was subject to only a per-country limitation. Internal Revenue Code of 1954, Pub. L. No. 83-591, sec. 904(a). During the period from 1960 to 1975, taxpayers could choose whichever of the two limitations (overall or per-country) was more favorable. Pub. L. No. 86-780, Sec. [1](a). The per-country limitation was repealed in 1976. Pub. L. No. 94-445, Sec. 1031(a).

527 Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other Code sections. See, e.g., secs. 865(h), 901(j), and 904(h)(10).

528 Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain domestic international sales corporations and foreign sales corporations.

Subpart F inclusions of a United States shareholder are assigned to the appropriate separate limitation category by reference to the category of income out of which the dividend or other payment was made.[529] Under the present two-basket system, general category income of different types or from different countries may be credited against other general category income. Thus, foreign tax on income from a high-tax country in one category can be credited against U.S. tax otherwise due on income in the same category derived in a low-tax jurisdiction.

Subpart F

Under the subpart F rules, a 10 percent-or-greater U.S. shareholder ("United States shareholder") of a CFC is subject to U.S. tax currently on its pro rata shares of certain income earned by the CFC, whether or not such income is distributed to the shareholder. A CFC is defined generally as a foreign corporation with respect to which United States shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation. Income subject to current inclusion under subpart F includes foreign base company income.[530] Foreign base company income includes foreign personal holding company income,[531] foreign base company sales income,[532] and foreign base company services income.[533]

Foreign personal holding company income

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts. There are several exceptions to the general rule of current taxation on foreign personal holding company income.[534]

Foreign base company sales income

Foreign base company sales income generally consists of income derived by a CFC in connection with: (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the

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[529] Sec. 904(d)(3).

[530] Sec. 952(a).

[531] Sec. 954(a)(1).

[532] Sec. 954(a)(2).

[533] Sec. 954(a)(3); see also, sec. 954(a)(5) (foreign base company oil related income).

[534] For example, the exception for active financing income (secs. 953 and 954).

purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (1) through (4), the property must be both manufactured outside the CFC's country of incorporation and sold for use outside of that same country for the income from its sale to be considered foreign base company sales income.[535] Certain exceptions to this general rule may apply. For example, income from sales of property involving a related person may be excluded under section 954(d) if a prescribed manufacturing exception applies.

Foreign base company services income

Foreign base company services income generally consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related party,[536] including cases where substantial assistance contributing to the performance of services by a CFC has been furnished by a related person or persons.[537] Substantial assistance consists of assistance furnished (directly or indirectly) by a related U.S. person or persons to the CFC if the assistance satisfies an objective cost test. For purposes of the objective cost test, the term "assistance" includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related U.S. person to a CFC. The objective cost test is satisfied if the cost to the CFC of the assistance furnished by the related U.S. person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.[538]

Pricing for transfers of intangible property between related persons

The United States has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a related foreign company through aggressive transfer pricing that does not reflect an arm's-length result. Similarly, the domestic laws of most U.S. trading partners include rules on transfer pricing.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable

[535] Sec. 954(d)(1).

[536] Sec. 954(e).

[537] Treas. Reg. sec. 1.954-4(b)(1)(iv).

[538] Notice 2007-13, 2007-5 C.B. 410. Prior to the issuance of Notice 2007-13, the substantial assistance rules also included a subjective principal element test. Under the subjective principal element test, assistance in the form of direction, supervision, services or know-how were considered substantial if the assistance provided the CFC with skills which where were a principal element in producing the income from the performance of such services by the CFC.

income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length.

There is an additional test for transactions resulting in the transfer of intangible property, which provides that the income with respect to any transfer (or license) of certain intangible property to a related person must be commensurate with the income attributable to the intangible property.[539] Section 367(d) provides a related rule under which compensation, in the form of an imputed royalty stream, is required for an outbound transfer of intangible property in the context of an otherwise nontaxable reorganization transaction.

Commensurate-with-income principle

As discussed above, Congress responded to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property – including, in particular, high-profit-potential intangible property – by amending section 482 to include the commensurate-with-income principle.[540] The legislative history to this provision states that transfer pricing problems are "particularly acute" in the case of high-profit-potential intangible property.[541] The House Committee on Ways and Means Report (the "Committee Report") identified, as a recurrent problem, the absence of comparable arm's-length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's-length concept in the absence of real comparables.[542] The Committee Report concluded that, because of the "extreme difficulties" in determining whether arm's-length transfers between unrelated parties are comparable, it was appropriate to require payments made on a transfer of intangible property to a foreign affiliate to be commensurate with the income attributable to the intangible property.[543]

The commensurate-with-income principle was intended to address these problems by shifting the focus of transfer pricing analysis to the income actually derived from exploitation of the transferred intangible property, and away from the identification of questionably comparable third-party transactions. In particular, Congress intended that compensation for intangible property be determined by taking into account actual profit experience, and that pricing adjustments be made upon major variations in the annual amounts of revenue. While the legislative history did not address the relationship between the commensurate-with-income principle and the arm's-length standard, some commentators interpreted the principle as an "ex

[539] Sec. 482.

[540] H.R. Rep. No. 99-426, 423. This provision was added by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2563 (1986).

[541] *Ibid.*, p. 424.

[542] *Ibid.,* pp. 423-424.

[543] *Ibid.*, p. 425.

post" rule (i.e., actual profits would be used as the basis for re-determining the transfer price retroactively) which conflicted with the arm's-length standard.[544]

The Conference Report for the 1986 Act also directed the Internal Revenue Service (the "IRS") to conduct a comprehensive study of the transfer pricing rules.[545] Treasury and the IRS published the findings of this study in a notice commonly referred to as the "White Paper."[546] An important consequence of this conclusion, reflected in subsequently issued Treasury regulations, was that comparable third-party transactions would continue to play a role in determining appropriate transfer prices, at least in the case of "normal intangible property."[547] Normal intangible property was described as intangible property that is widely available to producers (such as the technology employed in pocket calculators, digital watches or microwaves) and for which "exact" comparables are more common. The White Paper concludes that in the case of high-value intangible property, transactions between unrelated parties involving comparable intangible property "almost never exist."[548]

The White Paper characterizes the commensurate-with-income principle as a clarification of prior law that it is consistent with the arm's-length standard.[549] In addition, the IRS applies the commensurate-with-income principle on an "ex ante" basis, meaning that actual profits are

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[544] See, e.g., Marc M. Levy and Stanley C. Ruchelman, "Section 482 -- The Super Royalty Provisions Adopt the Commensurate Standard," 41 *Tax Lawyer* 611 (Spring 1988) ("Rather than looking to the bona fides of the transfer at the time of the transfer, Congress intends that, notwithstanding such bona fides, payments must reflect the actual profit experience realized as a consequence of the transfer. Reliance on reasonably calculated, projected profit experience is insufficient. Further, a payment set at the time of transfer and measured as a percentage of sales is insufficient. Thus, taxpayers must initially justify the reasonableness of an intercompany transfer pricing agreement under the facts and circumstances existing at the time entered and must subsequently justify any adjusting payments that reflect the actual profit experience realized as a consequence of the transfer. In essence, a 'floating' payment rate that can be adjusted upward to reflect greater than anticipated profit experience is the new measure" (citations omitted)); see also E.C. Lashbrooke, Jr., "I.R.C. §482 Commensurate with Income Standard for Transfers of Intangibles," 1 *DePaul Business Law Journal* 173 (1989), p. 186 ("The Congressional mandate that adjustments be made to allocations of income to reflect actual profit experience clearly is a rejection of the holding in *R.T. French v. Commissioner* and similar cases that the determination of a section 482 allocation be based solely on the facts and circumstances in existence at the time of transfer").

[545] H.R. Conf. Rep. No. 99-841, pt. 2 (hereafter "Conference Report 99-841"), p. II-638.

[546] Notice 88-123, 1988-2 C.B. 458 (hereafter, the "White Paper").

[547] *Ibid.*, p. 473.

[548] *Ibid.* However, the White Paper states that in the rare instance in which there is a true comparable for a high-profit intangible property, the transfer price must be set on the basis of the comparable transaction, because that remains the best measure of how third parties would allocate income from intangible property.

[549] *Ibid.*, p. 472. The White Paper bases this conclusion on a statement in Conference Report 99-841 that income from a transferred intangible property should be divided based on the relative economic contributions of the parties. The White Paper states that this approach is consistent with what unrelated parties do and concludes from this that the general goal of the commensurate-with-income requirement is "to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's-length transfer of the intangible."

taken into account for purposes of determining if the initial transfer price was appropriate. Thus, the IRS view is that commensurate with the income attributable to the intangible property "refers generally to the operating profits that the taxpayer would reasonably and conscientiously have projected at the time it entered into the controlled transaction."[550]

Methods of transferring intangible property

A U.S. person that develops or purchases intangible property generally can make that intangible property available to a related person (typically, a foreign affiliate) in four ways. The first is through an outright transfer of all substantial rights in the intangible property, either by sale or through a non-recognition transaction (for example, a capital contribution of the intangible property to the affiliate in an exchange that meets the requirements of section 351, or an exchange made pursuant to a plan of reorganization that is described in section 361). The second is through a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate.[551] The third is the provision of a service using the intangible property.

In the fourth, intangible property is made available through a cost-sharing arrangement. In one example of a cost-sharing arrangement, a U.S. company and one or more foreign affiliates make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable product or service. The U.S. company makes available all, or a substantial portion, of the rights to use and further develop existing intangible property, and the foreign affiliate (typically organized in low-tax jurisdiction) generally contributes cash. The arrangement provides that the U.S. company owns legal title to, and all U.S. marketing and production rights in, the developed property, and that the other party (or parties) owns rights to all marketing and production for the rest of the world.[552] Reflecting the split economic ownership of the newly developed asset, no royalties are paid between cost sharing participants when the product is ultimately marketed and sold to

[550] AM-2007-07 (March 23, 2007): pp. 3, 12. The Advisory Memorandum states that concerns were expressed in both the legislative history and in the White Paper regarding the ability of the IRS to examine, after the fact, taxpayers' expectations regarding potential profits. The Advisory Memorandum concludes that the intention of the commensurate-with-income requirement is to give the IRS a presumptive basis for making periodic adjustments, which taxpayers could then rebut, for example, by showing that the actual results were beyond the control of the taxpayer and could not reasonably have been anticipated at the time of the transaction.

[551] The significance of the retained residual rights depends, in part, on the length of the license term as well as any restriction (express or implied by the taxpayer's conduct) on any potential competing use of the retained rights in the area of use belonging to the licensee.

[552] There are numerous variations on this basic description of a typical cost-sharing arrangement. For example, another approach may allocate cost sharing (and, therefore, the entitlement to profits) by product or by region (e.g., the U.S. cost-sharing participant may be allocated North America, while the foreign cost-sharing participant is allocated the rest of the world, or the U.S. cost-sharing participant is allocated products A, B and C, while the foreign cost-sharing participant is allocated products X, Y, and Z). In addition, any participant in a cost-sharing arrangement may contribute its existing intangible property to a cost-sharing arrangement (e.g., if a foreign subsidiary owns the rights to product X, the foreign subsidiary and its U.S. parent may cost share the next generation of product X).

customers. However, the U.S. company receives a buy-in payment[553] (such as periodic royalties or a lump sum payment at the outset) from the other cost-sharing participant with respect to its "platform contribution."[554]

The mechanism used for transferring intangible property to a foreign affiliate frequently dictates whether the authority for determining the compensation received by the U.S. person in the transaction is under section 482 or section 367(d). Generally, a license or a sale of intangible property, or the provision of a service that uses intangible property, is subject to section 482. An exchange of intangible property in connection with certain nonrecognition transactions is subject to section 367(d), which overrides the general nonrecognition rules of sections 351 and 361 to require that the transferor of intangible property include imputed income from annual payments over the useful life of the intangible property, as though the transferor had sold the intangible property (at whatever stage of development it is, from an entirely undeveloped idea through, and including, a completely developed and exploitable item of intangible property), at times in exchange for contingent payments. The appropriate amounts of those imputed payments are determined under section 482 and the regulations thereunder. Transfers of foreign goodwill or going concern value are specifically exempt from the income recognition provisions of section 367(d).[555] With respect to cost-sharing arrangements, specified rights to existing intangible property can be transferred to other cost-sharing participants either through a sale or a license.[556]

Section 482 regulations

In general

A transaction between related parties meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if unrelated taxpayers had engaged in the same transaction under the same circumstances.[557] Because identical

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553 Present regulations refer to "buy-in payments" as "PCT payments," (i.e., payments for platform contribution transactions). Temp. Treas. Reg. sec. 1.482-7T(b)(ii). The more common term, "buy-in payment," is used herein. The buy-in payment eliminates the benefit of expense deductions for research and development ("R&D") previously performed in the United States; amounts received in excess of previously deducted R&D expenses incurred should represent the present value of the intangible property transferred, discounted for the risk assumed by the transferee. The ongoing cost-sharing payments offset any deductions that the recipient of such payment takes for post-buy-in R&D activities. Such ongoing cost sharing does not, however, include compensation for the expected above normal return on any products that may result from that R&D.

554 In this context, a "platform contribution" is any resource, capability, or right that the U.S. company has developed, maintained or acquired outside of the cost-sharing arrangement, that is reasonably anticipated to contribute to the development of cost-shared intangible property. Temp. Treas. Reg. sec. 1.482-7T(c)(1). Implicit in the definition of a platform contribution is that the resource, capability, or right is made available through the cost-sharing arrangement.

555 Temp. Treas. Reg. sec. 1.367(d)-1T(b).

556 A taxpayer might choose a fixed lump sum form of payment if it has net operating losses in the United States that would offset the income from the transfer of the intangible property. In the absence of net operating losses, taxpayers might choose a contingent form of periodic payments.

557 Treas. Reg. sec. 1.482-1(b)(1).

transactions between unrelated parties are rare, whether a transaction produces an arm's-length result generally is determined by reference to the results of transactions deemed to be comparable under circumstances deemed to be comparable.[558] To evaluate comparability, the regulations require an analysis of all factors that could affect prices or profits in uncontrolled transactions. Each method requires an analysis of all the factors that affect comparability under that method, and a specific comparability factor may be particularly important to a particular method.[559] The comparability factors include: (1) functions; (2) contractual terms; (3) risks; (4) economic conditions; and (5) the property or services transferred.[560]

Transfer pricing rules do not require that a comparable transaction be identical to the related party transaction, but it must be sufficiently similar to the related-party transaction to provide a reasonable starting point for determining the arm's-length price.[561] If there are material differences between the related-party transaction and the comparable transaction, adjustments are be made to the relevant formulas, but only if it is possible to determine the impact of those differences on prices or profits with sufficient accuracy.[562] If it is not possible to determine the impact of those differences on prices or profits with sufficient accuracy, the comparable transaction may be taken into account in establishing the arm's-length price, but it is considered a less-reliable measure of an arm's-length result.

In many cases, risk can be assigned by contract within an affiliated group to entities with the objective ability to bear such risk. However, whether the risks in the related party transaction and in the comparable transaction are, in fact, comparable may be difficult to ascertain. Nonetheless, the respect given to contractual agreements between related companies is derived from the longstanding doctrine of *Moline Properties v. Commissioner*,[563] in which the Supreme Court rejected the taxpayer's attempt to disregard the corporate form.[564] Under the doctrine of corporate entity articulated in *Moline Properties*, the corporation remains a separate taxable entity, provided the purpose of the corporation is the equivalent of a business activity or the carrying on of a business by the corporation.[565]

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[558] *Ibid.*

[559] Treas. Reg. sec. 1.482-1(d)(1).

[560] *Ibid.*

[561] Treas. Reg. sec. 1.482-1(d)(2).

[562] *Ibid.*

[563] 319 U.S. 436 (1943).

[564] Although *Moline Properties* involved an individual shareholder, this rule applies equally to a corporation and its subsidiaries. *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 433 (1949).

[565] *Moline Properties v. Commissioner*, 319 U.S. 436, 439 (1943), citing *New Colonial Co. v. Helvering*, 292 U.S. 435, 442 and *Deputy v. Pont*, 308 U.S. 488, 494. In contrast, new section 7701(o)(1) provides that a transaction is treated as having economic substance only if (1) the transaction changes "in a meaningful way" (apart from federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a "substantial purpose"

Transfers of intangible property

Treasury regulations issued in 1994 set forth the basic rules for determining income in connection with a transfer of intangible property.[566] These regulations generally provide that the arm's-length consideration for the transfer of intangible property in a controlled transaction (i.e., a transaction between related entities) must be commensurate with the income attributable to the intangible property, and it requires taxpayers to apply one of four methods to meet this requirement.[567]

Comparable uncontrolled transaction method.—The comparable uncontrolled transaction method evaluates the amount charged for intangible property in a controlled transaction by reference to the amount charged in a comparable uncontrolled transaction (i.e., a transaction between unrelated parties).[568] The regulations provide that if an uncontrolled transaction involves the transfer of the same intangible property under the same, or substantially the same, circumstances as the controlled transaction (i.e., an exact comparable), the comparable uncontrolled transaction method generally is the most direct and reliable measure of the arm's-length result for a controlled transaction.[569] Exact comparables are rare, however, in the case of high-value intangible property. If an exact comparable uncontrolled transaction cannot be identified, uncontrolled transactions that involve the transfer of comparable intangible property under comparable circumstances (i.e., inexact comparables) may be used to apply the comparable uncontrolled transaction method, but the reliability of the method will be reduced. The regulations require that a taxpayer consider whether the intangible property that is the subject of the uncontrolled transaction has "similar profit potential" to the taxpayer's intangible property in determining whether the uncontrolled transaction is comparable.[570] However, this method does not otherwise consider or directly reflect the income attributable to the taxpayer's intangible property.

(apart from federal income tax effects) for entering into such transaction. For discussion of the choice to utilize a related-affiliate in a transaction, see the text with footnote 349 in Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act"* (JCX-18-10), March 21, 2010, p. 153.

[566] Treas. Reg. sec. 1.482-4.

[567] The regulation also permits the use of other unspecified methods, which must take into account the prices or profits that the related taxpayer could have realized by choosing a realistic alternative to the related-party transaction. Treas. Reg. sec. 1.482-4(d)(1). A taxpayer must apply any method, whether specified or unspecified, in accordance with the overall requirements of Treas. Reg. sec. 1.482-1, including its best method, comparability analysis and arm's-length range rules.

[568] Treas. Reg. sec. 1.482-4(c)(1).

[569] Treas. Reg. sec. 1.482-4(c)(2)(ii). Circumstances between the related-party and unrelated-party transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made.

[570] Treas. Reg. sec. 1.482-4(c)(2)(iii)(B)(1)(ii).

The remaining methods require an examination of the income actually derived from the transferred intangible property. They differ, however, in the extent to which they rely on comparable uncontrolled transactions.

Comparable profits method.–The comparable profits method evaluates the amount charged in a controlled transaction by comparing the operating profit of the "tested party" (generally, the licensee) to the operating profits of uncontrolled taxpayers that engage in similar business activities under similar circumstances. For example, where a U.S. parent company licenses intangible property to a foreign manufacturing subsidiary, the royalty payable by the subsidiary to the parent is evaluated under this method by comparing the operating profit of the subsidiary to the operating profits of comparable uncontrolled manufacturers. If the subsidiary's profit level differs meaningfully from the profit levels of the uncontrolled manufacturers, the royalty rate paid by the subsidiary is adjusted as necessary to bring the profit level within an acceptable range. In effect, this method limits the extent to which income from the intangible property can be retained by the licensee to the amount that an uncontrolled licensee would be permitted to retain; the remainder of that income is required to be paid to the licensor through the royalty.[571]

Profit split methods.–The regulations also provide two profit split methods, under which the relative values of each controlled party's contribution to the combined profits from use of intangible property are used to determine an arm's-length "profit split." The arm's-length charge for the intangible property is the amount required to achieve the appropriate split of the combined profits.

The comparable profit split method relies exclusively on external market data to determine the appropriate profit split; thus, the combined operating profits of controlled taxpayers are split based on the split of combined operating profits of uncontrolled taxpayers with similar transactions and activities in the relevant business activity.[572]

The residual profit split method relies on external transactions principally in order to determine the amount appropriately allocable to routine contributions and, in some cases, to determine the split of residual nonroutine return amongst the parties.[573] Under this method, income is first allocated to the routine contributions of the controlled parties (including contributions of routine intangible property) based on market returns, and the residual income is then allocated based on the relative value of each party's contribution of nonroutine property.

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[571] Treas. Reg. sec. 1.482-5, including *Example* (4).

[572] Treas. Reg. sec. 1.482-6.

[573] "Routine" contributions are generally contributions of the same, or of a similar kind, to those made by unrelated taxpayers involved in similar business activities for which it is possible to identify market returns. Treas. Reg. sec. 1.482-6(c)(3)(i)(A). Providing bookkeeping services and managing accounts payable for a cost-sharing arrangement is an example of a routine contribution of services, because bookkeeping services are frequently provided at arm's-length between unrelated parties. Therefore, comparable transactions should be readily available.

Periodic adjustments.−Periodic adjustments may be necessary to comply with the commensurate-with-income requirement.[574] When intangible property is transferred in an arrangement that covers more than one year, the consideration charged for each taxable year may be adjusted by the IRS (in the context of an examination of that year) to ensure that it is commensurate with the income from the intangible property. No adjustment will be required if the taxpayer satisfies various requirements, including that the profits earned (or cost savings) realized by the related taxpayer from the exploitation of the intangible property is not less than 80 percent, nor more than 120 percent, of the profits projected (or cost savings) at the time the related party arrangement was established.

Application of section 482 principles to unidentified intangible property

For purposes of sections 482 and 367(d), "intangible property" is defined by reference to section 936(h)(3)(B) and means any: (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item. The term "intangible property" contemplates that any such item must have substantial value independent of the services of any individual.[575]

Because they are not specifically mentioned in section 936(h), whether goodwill, going concern value and workforce in place are intangible property for which compensation must be provided is unsettled.[576]

Description of Proposal

The proposal to tax currently excess returns associated with transfers of intangible property offshore (the "subpart F proposal" or the "proposal") provides a new category of subpart F income, as well as a new separate foreign tax credit limitation basket. Under the proposal, if a U.S. person transfers intangible property from the United States to a related CFC that is subject to a low effective foreign tax rate in circumstances that evidence excessive income shifting, then an amount equal to the excessive return is treated as subpart F income. This excessive return income is currently includible in the income of the CFC's United States shareholders.

Effective date.−The subpart F proposal is effective for taxable years beginning after December 31, 2010.

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[574] Treas. Reg. sec. 1.482-4(f)(2).

[575] Treas. Reg. sec. 1.482-2A(d)(3)(i).

[576] For additional discussion of these items, see the Analysis Section of item VI.F.3 (Limit Shifting of Income Through Intangible Property Transfer) in this document.

Analysis

Policy rationale

Overview

The proposal seeks to reduce the financial incentive for transferring intangible property to a low-tax CFC that, after such transfer, derives the income associated with its exploitation of the intangible property. The policy concern is that such transfers have shifted income outside of the United States that would otherwise be subject to U.S. tax, resulting in erosion of the U.S. tax base. Transfer pricing rules provide a mechanism for protecting the U.S. tax base from artificial income shifting. However, the potential financial incentives of certain related-party transactions (particularly the financial incentives from those transactions involving transfers of intangible property to low-tax CFCs) have put significant pressure on the enforcement and effective application of transfer pricing rules. The subpart F proposal adopts a new approach to address this issue. In most situations, the net effect of the proposal is current U.S. taxation with little or no foreign tax credits on income where intangible property is transferred from the United States by a U.S. person to a related CFC (a covered transfer) organized in low-tax jurisdiction – which may approximate the tax consequences of retaining that intangible property in United States.

Minimum threshold of taxation as the prerequisite for deferral

The proposal increases the U.S. tax liability of affected taxpayers because it denies deferral for certain active business earnings that have previously enjoyed deferral from U.S. tax. The subpart F proposal could be viewed as effectively establishing a base foreign-tax threshold for deferral, such that certain foreign earnings that do not bear some minimum threshold level of source taxation are taxed currently in the United States. Although views differ, it has been observed that the U.S. deferral system approximates the exemption regimes of U.S. trading partners, thereby leveling the competitive landscape for U.S. companies in the global economy.[577] Arguably, the additional limitations on deferral imposed by the proposal may reduce the ability of some U.S. companies to compete against foreign rivals, raising the question whether the proposal fits better within a broader approach to overall tax reform.[578]

The presence of a causal connection between the actual intangible property transferred from the United States and the excessive return is not relevant under the proposal. Thus, the subpart F proposal does not distinguish between transfers of high-value intangible property and other types of intangible property. For example, if a CFC directly acquires a patent from an unrelated party (a transfer that is outside the scope of the proposal) for a process that revolutionizes widget manufacturing and significantly reduces its cost of goods sold, but it also

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[577] See, e.g., Office of Tax Policy, Department of the Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations," (December 2000): *Preamble*, p. x; Joint Committee on Taxation, *Options To Improve Tax Compliance And Reform Tax Expenditures* (JCS-02-05), January 27, 2005, p. 188.

[578] For discussion of different perspectives on the competitive implications of the Administration's proposals, see the Analysis Section of item VI.F.1 (Defer Deduction of Interest Expense Related to Deferred Income) in this document.

uses other manufacturing know-how[579] that is important − but not nearly as valuable − the CFC may enjoy a high rate of return that is primarily derived from the patented process. However, if the other manufacturing know-how is transferred to the CFC by a related U.S. person, the CFC may be subject to testing – and possible current taxation – under the proposal. If there is little or no demonstrable correlation between the intangible property transferred and the CFC's excessive return, it is unclear why the transfer of that manufacturing know-how adversely impacts the U.S. tax base.

There is precedent for imposing a minimum threshold of taxation for foreign income as a prerequisite to deferral. Under section 963, deferral of U.S. taxation was permitted on subpart F income only where sufficient earnings and profit ("E&P") were distributed to U.S. shareholders so as to produce an overall effective tax on current foreign profits equal to approximately 90 percent of the tax that would have been paid had the CFC been taxable as a domestic corporation.[580] As with the subpart F proposal, the minimum distribution level was determined based on the effective foreign tax rate of the CFC.[581] The proposal is also similar to section 963 in that, under the proposal, there may be taxpayers that are denied some measure of deferral even though the substance of their CFC activities match the form of their contractual arrangements, and the transfer price is in all respects an appropriate measure of an arm's-length result.[582]

On the other hand, if the proposal is revised and the intangible property transfer is eliminated as a threshold requirement, implementation and tax administration (discussed below) of the rule is streamlined. Eliminating the taint that the proposal imposes on intangible property transfers from the United States may reduce the incentive to both migrate intangible property development to CFCs and to have CFC's use offshore funds to acquire intangible property.

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579 If the manufacturing know-how is related to efficiency in a routine manufacturing process that most manufacturers develop over time through experience, and comparable transactions are readily available to establish an arm's-length price, the manufacturing know-how may be "routine intangible property." In contrast, the manufacturing know-how of a large team of engineers and skilled craftsmen assembled for purposes of developing or perfecting a complex manufacturing process that no other company is capable of repeating independently is likely not routine intangible property, as there are not comparable transactions readily available to establish an arm's-length price. See generally, "White Paper," pp. 488-490.

580 See sec. 963, repealed by Pub. L. No. 94-12, sec. 602(a)(1). Section 963 did not have a transfer pricing element similar to that of the proposal. H.R. Conf. Rep. No. 87-2508, 34 (1962) reprinted in 1962-3 C.B. 1129.

581 A different, but somewhat related, approach was articulated in 1998 by then Treasury Assistant Secretary (Tax Policy) Donald C. Lubick. With respect to the policy goal of minimizing and simplifying administrative burdens, Lubick noted that "Treasury might be able to drastically simplify subpart F by adopting an alternative rule eliminating the need to distinguish passive business income from active business income and mobile income from non-mobile income [by limiting subpart F] to those situations in which the effective rate of foreign tax on foreign income is below a threshold and would not apply if income is subject to foreign tax at or in excess of the threshold." Albertina M. Fernandez, et al., "IRS, GW Hold Annual International Tax Institute," *Tax Notes* 81 (December 21, 1998): pp. 1467, 1475.

582 Unlike the proposal, section 963 was intended to provide relief from subpart F. Following its enactment, it was described as setting "forth one of the most complex schemes ever to be devised in the history of tax legislation..." Rexford R. Cherryman, "The New 'Subpart F' Foreign Income Provisions of the Internal Revenue Code," *William & Mary Law Review* 4 (1963): pp. 172, 202.

However, eliminating the intangible property transfer as a prerequisite to subpart F treatment under the proposal broadens the proposal beyond its stated policy objective (reducing the financial incentive to shift income to low-tax jurisdiction through outbound transfers of intangible property) and exposes the proposal to increased controversy as a limited repeal of deferral.[583]

<u>No direct changes to the arm's-length standard</u>

Transfer pricing issues are among the more significant faced by the IRS in its tax administration efforts.[584] Among the difficulties is the intensive case-by-case intervention required to resolve factual disputes in transfer pricing cases. Although the effectiveness of the arm's-length standard as the measure of transfer prices is sometimes debated,[585] the proposal avoids this debate by addressing excessive income shifting through subpart F, rather than through any direct changes to the transfer pricing rules of section 482. To the extent the proposal avoids changing transfer pricing rules, proponents may view it as complementing section 482 and providing a targeted antiabuse rule.

A rationale for taking this approach − rather than modifying the arm's-length standard[586] − is that such a modification could be criticized as disruptive to relations with U.S. trading partners.[587] Following the leadership of the United States, most countries (including all of the

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[583] To eliminate the behavioral response that would result from a rule based on a threshold effective foreign tax rate, one commentator has suggested modifying the proposal as an explicit, albeit limited, repeal of deferral, by subjecting the first 10 percent of a CFC's earnings to tax currently. Martin A. Sullivan, "Should the U.S. Limit 'Excessive' Returns in Low-Tax Countries?" *Tax Notes* 126 (March 15, 2010): pp. 1301, 1302.

[584] See, e.g., Prepared remarks of Douglas H. Shulman, George Washington University Law School, *22ND Annual Institute on Current Issues on International Taxation*, Washington, D.C., IR-2006-116 (December 10, 2009); Randall Jackson, "Increased Efficiency, Transfer Pricing Pilot Cases Top LMSB Agenda, Official Says," *Tax Notes Today,* 71-9 (April 14, 2010).

[585] See, e.g., Marie Sapirie, "Arm's-Length Standard Contested at Ways and Means Hearing," *Tax Notes Today,* 141-2 (July 23, 2010) (reporting the remarks of Stephen Shay, Deputy Assistant Secretary for International Tax Affairs, U.S. Treasury Department); Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length," *Tax Notes* 30 (February 17, 1986): p. 625; Michael C. Durst, "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws," *Tax Notes International* 57 (January 18, 2010): p. 247.

[586] For a discussion of the history of the arm's-length standard, which dates back to 1935, see Rueven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," *Virginia Tax Review* 15 (hereafter "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation"): p. 89; see also, "White Paper," pp. 459 - 461.

[587] This outcome was the case when Congress adopted the second sentence of section 482, which requires the use of hindsight (through analysis of actual profit experience) in making section 482 adjustments with respect to income derived from the transfer of intangible property. Pub. L. No. 99-514 (October 22, 1986). Although the legislative history to the Tax Reform Act of 1986 did not address the relationship between the commensurate-with-income principle and the arm's-length standard, many commentators viewed the new provision as overriding the arm's-length standard. See, e.g., Marc M. Levey and Stanley C. Ruchelman, "Section 482 -- The Super Royalty Provisions Adopt the Commensurate Standard," *Tax Lawyer* 41 (Spring 1988): p. 611; E.C. Lashbrooke, Jr., "I.R.C. §482 Commensurate with Income Standard for Transfers of Intangibles," *DePaul Business Law Journal* 1 (1989): pp. 183, 186; W. Scott McShan, Michael J. Merwin, Garry B. Stone, and Delores R. Wright, "Section 482 White

member countries of the Organisation of Economic Co-operation and Development, the "OECD") adopted and now follow the arm's-length standard.[588]

Another view of the proposal is that it is consistent with the arm's-length standard, but serves indirectly to reduce the importance of risk in determining comparability. Some have argued that accounting for assignment of risk in transactions between related parties is a weak point in the arm's-length standard.[589] Arguably, transfers to related parties normally do not involve the bona fide shifting of economic risk that would occur in transactions between unrelated parties. This is because the separate existence of each company in the group is respected, therefore risk can be assigned by contract to any member of the group with the objective ability to bear that risk, even though risk does not leave the affiliated group.

Outbound transfers of intangible property tend to be accompanied by assignment of risk related to the commercialization of the intangible property transferred. These concurrent transfers of intangible property and risk to the CFC highlight that risk (and the associated profit) is very mobile.[590] Mobility of income is addressed under present law by the subpart F rules, which are designed to prevent the diversion of certain income (including both passive and mobile income) from U.S. taxation. The proposal adopts the mechanics of subpart F to tax currently the mobile profits associated with assigned risk.[591]

However, some may criticize the proposal's distinction between normal and excessive returns because it is not clear that the distinction is based on a measurement of the profits associated with assigned risk. As a result, active business profits derived by a CFC from a

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Paper . . . A Review of Third-Party License Agreements: Are Periodic Adjustments Arm's Length?" *Tax Executive* 41 (July-August 1989): p. 353. In contrast, Treasury and the IRS characterized this requirement as a clarification of prior law, concluding that it is consistent with the arm's-length standard. "White Paper," p. 472. This conclusion may have been influenced by the "strong objections by our trading partners to the language contained in the 1986 legislative history advocating abandonment of the [arm's-length standard]," as well as concerns expressed by U.S. taxpayers that deviating from the arm's-length standard would be inconsistent with international norms and would increase the possibility of double taxation. "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," p. 133.

[588] "White Paper," p. 475.

[589] See, e.g., Robert H. Dilworth, "Tax Reform: International Tax Issues and Some Proposals," *International Tax Journal* (January - February 2009): pp. 5, 94 and Michael Durst, "Congress Fix Transfer Pricing and Protect U.S. Competitiveness," *Tax Notes* 128 (July 26, 2010): pp.401, 403.

[590] See Kristen Parillo, "Obama Administration Still Vigilant on Check the Box," *Tax Notes Today*, 56-2 (March 24, 2010) (reporting the remarks of Manal Corwin, International Tax Counsel, U.S. Treasury Department); Kristen Parillo, "Intangible Asset Proposal Will Not Displace Transfer Pricing," *Tax Notes* 126 (March 1, 2010): p. 1028 (quoting Manal Corwin, who said that "[t]here are also transfers that involve a shift of profits associated with risk, which is an economic concept that's well supported and consistent with transfer pricing principles – but risk is a very mobile thing.")

[591] *Ibid.* (summarizing the comments of official as follows: "the Administration took the view that it should approach the shifting of risk that carries significant profits in the same way the U.S. antideferral rules focus on having current taxation on passive or mobile income").

transaction that is appropriately priced under the arm's-length standard could be taxed currently in the United States.

Potential incentive to repatriate foreign earnings

Once the CFC's earnings have been taxed as an excessive return under subpart F, there is no tax incentive to retain those earnings outside of the United States. Thus, the proposal may have the effect of encouraging repatriation of some previously-taxed foreign income.

On the other hand, a taxpayer in a low-tax jurisdiction, which would otherwise be subject to the proposed subpart F inclusion, may find it beneficial to expand its activities in the low-tax jurisdiction, rather than repatriate income or increase royalty payments. Some taxpayers both hold intangible property and manufacture at the same low-tax CFC. The rate of return attributed to the manufacturing enterprise generally is lower than the rate of return attributed to the intangible property. If such a taxpayer were subject to a subpart F inclusion for an excessive return based on its current operations, expansion of its manufacturing (or other lower-rate of return operations) in the low-tax jurisdiction could cause the taxpayer's overall rate of return to fall below the proposal's excessive return threshold. Such an expansion of manufacturing operations could come from shifting operations into the low-tax jurisdiction from other foreign jurisdictions or from the United States. If the CFC takes such steps to expand its investment base, there would be no increase in foreign-source income paid back into the United States, and there could be an increase in the taxpayer's overall foreign-source income compared to U.S. source income.

The subpart F proposal establishes a separate limitation category for an excessive return taxed currently; however, the proposal does not otherwise modify the foreign tax credit rules. Thus, a foreign tax credit is provided with respect to any source country taxes paid by the transferee. It is not clear whether the proposal contemplates one excessive return basket, or a separate excessive return basket for each CFC. However, cross-crediting[592] opportunities with respect to excessive return income may be effectively limited by the one-basket approach because this income is, by definition, low-tax. In addition, subpart F income from an excessive return is not included in any limitation basket income when repatriated, including general basket income, because it is previously taxed income. Consequently, the proposal may also diminish cross-crediting opportunities for higher-taxed income in the general limitation basket on future distributions.

The proposal may lead some taxpayers to choose to receive royalty income (currently taxable when received in the United States) rather than income subject to current inclusion under subpart F as an excessive return. Royalty payments are generally a deductible expense in the country from which they are paid. Therefore, royalty payments reduce the measured return attributable to the foreign jurisdiction. A reduced investment return in the foreign jurisdiction reduces the likelihood that the taxpayer would be subject to the proposed subpart F inclusion.

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[592] Cross-crediting refers to the repatriation of highly taxed foreign earnings and using credits generated by this highly taxed income to offset U.S. tax on other lightly taxed foreign income in the same foreign the same type of foreign tax credit limitation basket.

Although additional royalty payments to the United States, like subpart F income from an excessive return, are taxed currently, the U.S. tax consequences may not be equal. This is because cross-crediting for royalty income is not affected by the proposal, as royalty income is not included in the excessive return basket for foreign tax credit purposes.[593] Moreover, a number of U.S. tax treaties reduce or eliminate withholding taxes on royalties. Therefore, any additional tax liability that results from increased royalty income to the United States is likely to be less than the additional tax liability that results from recognizing subpart F income on an excessive return. However, the taxpayer must substantiate any increased royalty payment under the arm's-length standard, possibly by reducing the risks and functions undertaken by the CFC.

The net tax consequences to a taxpayer that increases royalty payments to other (non-U.S.) jurisdictions would depend on many factors, but taxpayers can be expected to structure their royalty payments to minimize or eliminate withholding tax on royalty payments from the CFC, minimize or eliminate income tax to the recipient of the royalty, and avoid inclusion in U.S. income (based on the look-through rule of section 956(c)(6)) under subpart F.

Technical issues not addressed by the proposal

The subpart F proposal provides only the basic framework for identifying subpart F income from an excessive return. The proposal articulates a three-part test, the elements of which need to be further defined, to determine if the CFC has income that is subject to tax currently: (1) a low effective foreign tax rate; (2) an excessive return; and (3) a covered transfer (i.e., the transfer of intangible property from the United States by a U.S. person to a related CFC). Where this three-part test is met, the taxpayer is subject to tax currently on subpart F income from an excessive return.

Low effective foreign tax rate threshold

The proposal does not state the threshold at which an effective tax rate is considered low. There are two principal considerations with respect to determining this threshold. The first is identifying the basis on which to select the threshold rate. The second is the method for calculating that rate.

Selecting the threshold rate

Selecting the threshold tax rate at which to trigger application of the provision appears aimed at requiring that earnings be subject to some minimum level of tax in the year earned. The subpart F proposal is designed as a cliff, such that at or below a threshold effective foreign tax rate, the excessive return of a CFC to which intangible property has been transferred by a U.S. person are taxed currently; above that threshold, the same returns are not considered as evidence of excessive income shifting, and are not taxed currently.

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[593] As described in more detail in Section VI.F.2 (Proposal to determine the foreign tax credit on a pooling basis), the foreign tax credit pooling proposal would not eliminate all opportunities to cross-credit high-tax income against low-tax royalties.

Some countries with participation exemption regimes (i.e., territorial tax systems) impose tax on foreign earnings that have not already been subject to some minimum level of tax. In selecting the rate at which to establish this threshold, analyzing this feature of these participation exemption regimes could provide informative examples of how other countries address income shifting.[594]

One may expect taxpayers to adjust investment decisions in response to whatever threshold is selected. For example, taxpayers may be willing to accept a somewhat higher foreign statutory tax rate if doing so provides insurance against unintentionally falling below the effective foreign tax rate threshold and triggering subpart F income. Over time, this potential for avoiding the provision could cause taxpayers to migrate operations to countries with a somewhat higher statutory tax rate. If the objective of the proposal is to ensure that a specified minimum threshold of tax is paid on certain foreign income, this migration would effectuate that objective. On the other hand, if the objective is to forestall covered transfers, this migration may perpetuate the existing problem, albeit with CFCs organized in different jurisdictions. Further, depending on the threshold rate that is selected, this could include migration from countries which are treaty partners. As a result, a treaty partner with a low statutory tax rate could argue that the subpart F proposal discourages future investment in that particular treaty country, and possibly – over time – encourage disinvestment by some taxpayers.

Method of calculating the CFC's effective foreign tax rate

By basing a subpart F inclusion on a low effective foreign tax rate, rather than a low statutory tax rate, the proposal focuses on the CFC's actual tax liability in the foreign jurisdiction. Current U.S. tax is potentially imposed under the proposal where the CFC has little or no tax liability in the jurisdiction in which the income is earned. While basing the threshold on the effective foreign tax rate imposes a greater administrative burden on taxpayers and the IRS, statutory foreign tax rates can be unreliable indicators as a result of negotiated tax grants or tax rulings. A taxpayer with a CFC that negotiates or is otherwise entitled to a preferential tax regime may enjoy an effective tax rate that is potentially well below the statutory tax rate in such jurisdictions.

As the proposal intends to use an effective tax rate standard, there are three primary design features to consider: (1) over what period of time to calculate the effective tax rate; (2) whether to use U.S. or foreign tax principles to calculate the effective foreign tax rate; and (3) the treatment of transfers to disregarded entities and actual branches.

Time period of the calculation.–A taxpayer may have a low effective tax rate in any particular year for a variety of reasons. For example, the taxpayer may have incurred losses in a prior year that the taxpayer is carrying forward to offset current earnings. Similarly, if effective

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[594] For example, amongst the countries that do not grant a participation exemption to "tax-advantaged" income: (1) Belgium generally requires a minimum 15-percent tax for non-European Union holdings; (2) for holdings in non-treaty countries, Spain requires a tax rate equivalent to the Spanish corporate income tax of 30 percent; and (3) France requires an effective taxation rate of at least 50 percent of its tax rate, which is 33.33 percent.

foreign tax rate is determined under U.S. tax principles (discussed below), timing differences (e.g., temporary timing differences resulting from disparate depreciation allowances) may cause variations that may not be present if the effective foreign tax rate is determined under foreign tax principles. While over time such differences reverse, in some circumstances the taxpayer may have already borne the burden of current U.S. taxation resulting from an excessive return. If the proposal's policy rationale is to discourage the transfer of intangible property to low-tax jurisdictions, consideration should be given to whether a one-year, or a multi-year, measure of an effective tax rate more accurately identifies low-tax jurisdictions.

U.S. or foreign tax principles.–The subpart F proposal could determine the effective foreign tax rate based on either U.S. or foreign tax principles. Both approaches are reflected in current subpart F rules. For example, the high-tax exception of section 954(b)(4) determines the effective tax rate imposed on income based on the taxes deemed paid under section 960,[595] a U.S. tax principle. In contrast, the sales and manufacturing branch rules apply a tax rate disparity test to determine if the use of a branch in a different country for such activities has substantially the same effect as if it were a subsidiary of the CFC.[596] The tax rate disparity test is based on foreign law principles.[597]

Arguably, the policy behind the subpart F proposal is closer to that of the high-tax exception than to that of the tax rate disparity test. Under the tax rate disparity test, the goal is to determine whether there is an undue advantage in using a branch to segregate certain activities into separate (non-U.S.) countries. Thus, the tax rate disparity test is intended to identify the difference that actually results under local tax, thereby making it logical to apply foreign law concepts. On the other hand, the high-tax exception implies that a current income inclusion is not required in advance of repatriation if the foreign tax credit on the relevant income indicates the income-producing property was not moved to the CFC because of the tax rate in the CFC's country of organization. This is similar to the underlying objective of the subpart F proposal, which is targeting transfers of intangible property to low-tax jurisdictions. Specifically, under the proposal, there is no evidence of excessive income shifting if the intangible property is transferred to a relatively high-tax jurisdiction. This similarity suggests that U.S. tax principles should be applied when determining the effective foreign tax rate of the CFC.

Moreover, if the CFC's effective foreign tax rate is determined based on foreign principles, the IRS would be required to audit effective foreign tax rate calculations based on unfamiliar rules. This imposes additional burdens on the IRS, which it has intentionally avoided in the past.[598]

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[595] Treas. Reg. sec. 1.954-1(d)(3)(i).

[596] Treas. Reg. sec. 1.954-3(b)(1).

[597] Treas. Reg. sec. 1.954-3(b)(1)(i)(c)(2)(ii); see also, Treas. Reg. sec. 1.954-3(b)(1)(i)(b), -3(b)(1)(ii)(b); see also PLRs 200945036 and 200942034.

[598] The preamble to the regulations which implemented the high-tax exception of section 954(b)(4) states that such a rule would impose a significant burden on the IRS. See 1995-2 C.B. 89, 91.

However, taxpayers can be expected to selectively structure their transactions to take advantage of differences between the foreign tax base (on which the CFC's actual tax liability is determined) and the U.S. tax base. Such strategies likely will be designed to decrease the U.S. tax base in comparison to the foreign tax base. As a result, the foreign tax would be greater as a relative percentage of E&P, which has the effect of increasing the effective foreign tax rate.

Transfers to disregarded entities and actual branches.–The third consideration is how to measure the effective foreign tax rate with respect to transfers to either: (1) an eligible entity that has "checked-the-box" and elected to be disregarded as separate from its owner (a so-called "disregarded entity"); (2) an actual foreign branch; or (3) a CFC with pass-through investments. If either a disregarded entity or the actual foreign branch is respected, then the transfer may be treated as a transfer to the CFC. When determining the effective foreign tax rate of the CFC owner, the calculation is made based on the blended effective foreign tax rate incorporating the income and taxes of the actual CFC plus any pass through investments, such as: (1) the disregarded entity or the actual foreign branch; (2) any other disregarded entities or actual branches owned by the CFC and (3) any partnership items attributable to the CFC.

If a taxpayer were to contribute assets to the CFC to increase its effective foreign tax rate and thereby avoid application of the proposal, the taxpayer would be engaged in a practice referred to as "stuffing." For an example of stuffing, assume that a CFC with a low-tax rate has only one investment, intangible property that it acquired in a covered transfer. The low-tax CFC owns no subsidiaries, nor any other disregarded entities or actual branches. At the beginning of the tax year, the taxpayer determines that the low-tax CFC will have both a low effective tax rate and an excessive return. To avoid a subpart F inclusion for an excessive return, the taxpayer contributes a group of wholly-owned CFCs, each of which is a relatively high-tax CFC, to the low-tax CFC in exchange for shares; each of the high-tax CFCs then elect to be disregarded as separate from their owner (the low-tax CFC). The transactions qualify for nonrecognition treatment for U.S. tax purposes. Without an "antistuffing" rule, the annual tax liability of high-tax CFCs would be combined with any tax paid by the low-tax CFC when computing the effective tax rate of the low-tax CFC. If the blended effective tax rate exceeds the threshold, then there is no possibility of an income inclusion for an excessive return under subpart F. Arguably, this is not consistent with the intent of the proposal.

In contrast, if a disregarded entity or actual foreign branch is treated as a separate corporation, then a covered transfer to that disregarded entity or actual foreign branch may be treated as a covered transfer to a CFC. When determining the effective foreign tax rate of the transferee on a stand-alone basis, the local tax implications of the covered transfer could be isolated and more precisely determined.[599] This approach prevents taxpayers from selectively

[599] There is precedent in the Code and the regulations for treating a branch as a separate corporation for specific purposes. These rules date back to 1962, and were intended to prevent a CFC from using a foreign branch to avoid foreign base company sales income under subpart F. See, e.g., 954(d)(2) and Treas. Reg. sec. 1.954-3(b). However, Treasury and the IRS efforts to impose "branch rule" treatment on income (including royalties) under the foreign personal holding company provisions were the subject of vigorous challenge. The Internal Revenue Service Restructuring and Reform Act of 1998 is an example of a legislative proposal that provided a vehicle for imposing a moratorium on the implementation of regulations proposed in conjunction with the issuance of Notice 98-11 (1998-1 C.B. 433) until considered by the Congress. See, e.g., S. Rep. 105-174 reprinted in 1998-3 C.B. 537, 645- 650.

avoiding the application of the subpart F proposal by blending high-tax and low-tax operations within a CFC so as to exceed the threshold effective foreign tax rate.

Excessive return

The second element of the subpart F proposal is a determination that there is an excessive return to the CFC. A threshold question is whether returns are determined on a pre-tax or after-tax basis. The proposal does not describe the base against which the return is to be measured as normal or excessive. Further, the proposal does not require any causal connection between the transferred intangible property the excessive return earned by the CFC. To the extent a CFC is able – based on its own unique circumstances – to produce returns in excess of whatever threshold were to be selected, the use of such threshold may be perceived as subjecting income to current U.S. tax where such income was not artificially shifted from the United States.

Determining an excessive return by reference to returns on investment

One reason to transfer intangible property outside the United States is to make it available to a foreign manufacturer that makes and sells the goods that are produced based on the intangible property. Taxpayers employ various approaches for transferring intangible property.[600] In some cases, intangible property is transferred to a jurisdiction that does not impose any tax; typically, taxpayers do not make substantial investments in plant, property and equipment in such jurisdictions. In these situations, a low effective tax rate threshold may be a sufficient basis for targeting income shifting.

In other cases, intangible property is transferred to a jurisdiction that either imposes a relatively low tax on business income or in which taxpayers are able to negotiable favorable tax rulings that reduce or substantially eliminate local tax. While it may be more common for taxpayers to invest in plant, property and equipment and establish operations that generate high profit margins in these countries, there is no universal formula that prescribes how any given taxpayer will structure its legal form, capitalize its structure with cash and assets, or operate its business in such countries. In these situations, a low effective tax rate threshold may not be a sufficient basis for targeting income shifting because it does not distinguish between taxpayers that have made substantial investments in local operations and those that have minimal presence.

The excessive return threshold could be viewed as making this distinction. For example, the excessive return could be determined based on a CFC's measurable investment in the

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Ultimately, Treasury and the IRS withdrew the temporary regulations and announced their intention to issue a notice of proposed rulemaking covering hybrid transactions. Notice 98-35, 1998-2 C.B. 34. Accordingly, the moratorium was not enacted. Notably, unlike the foreign base company sales income rules of section 954(d), the foreign personal holding company provisions of 954(c) do not contemplate such a branch rule. In addition to the sales and manufacturing branch rules of subpart F, the subpart J rules regarding foreign currency transactions are applied to qualified business units, meaning any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books or records. Sec. 989(a).

[600] See generally, Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

jurisdiction, with any return in excess of a normal return on this investment constituting an excessive return. However, whether a universal standard applied equally across all businesses and industries could, in fact, do so in a manner that could be readily administrable by the IRS is unclear.

As an initial matter, the time period over which the return on investment is measured must be determined. For example, the return on investment could be determined on an annual basis, such that each year's return and each year's investment is isolated and stands alone. Alternatively, returns and investments could be averaged over a specific time period. This alternative approach takes into account that, for a successfully developed product, there is typically some lead time between (1) the initial investment, (2) initial commercialization, and (3) profitability. It also takes into account that profitability can be cyclical. As lead times and profit cycles vary both by industry and by product, it may be appropriate to permit taxpayers to elect either annual testing or testing based on a multi-year rolling average.

In addition, some may assume that the proposal intends to tax currently an excessive return derived specifically from the transferred intangible property, yet this is not stated in the proposal. Thus, another initial matter is whether an excessive return should be measured broadly, by reference to a CFC's earnings in aggregate, or in a more limited and targeted manner. If measured in a targeted manner, an excessive return could be measured by reference to earnings related to a specific transfer of intangible property, and the products derived from the use of that intangible property. This approach has the advantage of more closely linking the proposal to its stated purpose, but could be complicated to administer to the extent a CFC's business extends across multiple product lines and activities, and includes shared resources. If measured broadly, an excessive return could be diluted by combining high- and low-margin products in the same CFC. While easier to administer, this broad approach provides taxpayers a route for planning around, and thwarting the intent of, the subpart F proposal.

Measuring investment.−Defining an excessive return by reference to a CFC's return on investment requires careful consideration in defining the term "investment." Under a "balance sheet" approach, the investment base could be limited to those items reflected on the U.S. GAAP balance sheet of the tested CFC. Balance sheets for both CFC's and disregarded entities are reported on annual information reports.[601] Accordingly, limiting the calculation to investments reflected on the CFC's balance sheet provides a readily determinable and, within the subjective limits permitted by U.S. GAAP accounting principles, an objective basis for calculating an excessive return. However, a "balance sheet" approach leaves out potentially relevant expenses that the CFC incurs to earn the return on investment. In other words, the CFC's profits are derived not only by those tangible and intangible assets recorded on its balance sheet, but also by deductible expenses that are reflected in its income statement.

Under an "all monies expended" approach, the return on investment could take into account any expenses incurred to generate the tested CFC's return. The base of investment expenses includes the U.S. GAAP balance sheet of the tested CFC plus expenses that are not

[601] Schedule F, Form 5471 and 8858, respectively.

reflected on the balance sheet. For example, research and development ("R&D") costs that are deducted currently are generally not recorded as intangible property on the balance sheet. Similarly, a CFC may license complementary intangible property from a third party. A CFC that invests in developing its own intangible property or licenses complementary intangible property may enjoy high returns on those expenditures. Thus, an "all monies expended" approach may mitigate the potential for overstating an excessive return attributable to a transfer of intangible property from a related U.S. person. On the other hand, the "all monies expended" approach is more difficult to administer than a "balance sheet" approach.

Whether to include an antistuffing rule is also a consideration with respect determining an excessive return. In the example above, the balance sheets (and, in an all monies expended approach, any relevant expenses) of the high-tax CFCs would be combined with that of the low-tax CFC when computing the excessive return of the low-tax CFC. If the blended rate of return is normal, then there is no excessive return to include in current income under subpart F based on the proposal. Arguably, this is not consistent with the intent of the proposal. In contrast, with an antistuffing rule, an excessive return is measured as if disregarded entities or actual foreign branches are separate corporations. As with an antistuffing rule in the context of the effective foreign tax rate calculation, this approach prevents taxpayers from selectively avoiding the application of the subpart F proposal by blending high-return and low-return operations.

If return on investment is the basis of determining if there is an excessive return, there could be potentially disparate implications to basic business decisions. A fundamental business decision is whether to (1) build a factory (which results in a balance sheet asset) and "make" a product internally or (2) outsource production to an unrelated contract manufacturer (where no balance sheet asset results) and only "sell" the product. These "make or sell" decisions are often based on comparative internal rate of return calculations. Depending on how the excessive return is calculated, the subpart F proposal could distort the make or sell decisions. If the taxpayer makes the product, the measured rate of return may be lower than if the taxpayer were to choose only to sell it after production by a contract manufacturer. A lower effective tax rate could result from choosing to make the product, even if the contract manufacturer were the more economically efficient producer. As a result, a return on investment approach to distinguishing between a normal and an excessive return could increase the relative importance of tax liabilities in analyzing "make or sell" decisions.

<u>Determining an excessive return by reference to returns to risk</u>

Another approach is to define an excessive return by reference to the profits associated with the risk that is assigned to the CFC in the intangible property transfer. Total return (i.e., the total profit earned by the CFC with respect to its sale of a good or service) is comprised of two components, a risk-free rate of return (commonly thought of as the yield on a U.S. Treasury bond) plus a risk premium (the return to compensate for undertaking the risk underlying the investment).

As stated above, an important component in income shifting through intangible property migration is the mobile nature of risk. Commercialization of intangible property is speculative, as the success or failure of the product in which it is deployed (in its development, launch, continued market demand, and pricing) is inherently uncertain. In addition, other uncertainties exist, such as the potential that a product design is intrinsically flawed. Thus, under the arm's-length standard, risk is one of the primary factors on which comparability[602] – and therefore entitlement to system profits – is based.[603] As a result, the extent to which each party bears the underlying risks is a primary factor when evaluating whether there is an arm's-length result. This is true even for a related-party transaction occurring entirely within an affiliated group, where arrangements can be designed to shift risk (and therefore income) among distinct legal entities while, nonetheless, remaining inside the group. To address the mobile nature of risk, the subpart F proposal could be designed to target returns to risk as an excessive return.

Risk-adjusted transfer price.–To deny deferral for returns to risk, one approach is to use a risk-adjusted transfer price as the threshold between a normal and an excessive return. Specifically, the taxpayer's transfer price would be calculated "with," and "without," taking into account risk borne by the CFC in the "with" calculation; the difference is then taxed currently as a subpart F item. Implicit in this approach is that an excessive return is linked to a specific intangible property transfer and specific products derived from the use of that intangible property, assumptions not explicit in the proposal. This approach has the dual benefits of precisely targeting the highly mobile nature of risk and building on existing administrative documentation requirements, such that current transfer pricing documentation could be expanded to incorporate the new "without risk" analysis. On the other hand, this approach could be viewed as increasing complexity by mandating additional transfer pricing analysis and documentation.

Residual profit split.–Another approach is to define an excessive return by reference to the residual profit split method, applied without regard to any assignment of risk to the CFC. Under the residual profit split method, the value of the routine contributions of the CFC and the taxpayer (which has transferred intangible property) should be readily ascertainable, leaving only the residual profit associated with the parties' nonroutine contributions to allocate. Routine contributions include contributions of tangible property and services. The excessive return would be determined by subtracting the CFC's residual profit split (determined without regard to any assignment of risk to the CFC) from the CFC's actual return.

The advantage of this approach is that it accounts for high-value intangible property (and the risks taken thereon, if any) and other functions that the CFC contributes to the production of revenue. In addition, an excessive return is linked to a specific intangible property transfer and specific products derived from the use of that intangible property. On the other hand, this approach may result in an additional administrative burden – to both the IRS and to taxpayers – in those situations in which the transfer price is not initially established based on the residual profit split method. In these cases, taxpayers are required to complete, and the IRS to audit, a second transfer pricing analysis.

[602] Others include (1) the functions performed and the associated resources employed by the taxpayer and (2) the significant contractual terms (Treas. Reg. secs. 1.482-1(d)(3)(i) and -1(d)(3)(ii)), as well as economic conditions and property or services (Treas. Reg. secs. 1.482-1(d)(1)(iv) and - 1(d)(1)(v)).

[603] Treas. Reg. sec. 1.482-1(d)(3)(iii).

Covered transfers

The subpart F proposal applies to any CFC to which intangible property is transferred if the additional effective foreign tax rate and excessive return requirements were also met. Its application is based solely on: (1) the transfer from the United States; (2) of any intangible property; (3) from a U.S. person; (4) to a related CFC. The proposal does not enumerate the types of transfers that are covered, thus, in the absence of any limitations, it covers all transfers, including (1) transfers made by license arrangements, (2) the provision of services using embedded intangible property,[604] and (3) any transfer of intangible property from the United States, without regard to whether that intangible property was originally developed in the United States.

By its terms, the subpart F proposal does not appear to include the output that results from contract research performed in the United States at the expense of a foreign affiliate. Thus, if a CFC acquires intangible property from an unrelated third party or engages a U.S. affiliate to perform contract R&D services, the proposal does not apply.

Retroactivity to pre-effective date transfers

In many instances, intangible property is made available to a CFC pursuant to an agreement covering multiple years. For example, a CFC that is required to build facilities and develop supporting plant, property and equipment to make and sell a patented product may have a long-term license with the owner of the patent. Similarly, where the intangible property is made available pursuant to an outright transfer of rights, the useful life of the intangible property likely extends beyond the initial year in which it was transferred. Under the subpart F proposal, it is unclear whether a multi-year, or an outright, transfer made prior to the effective date is exempt from the proposal. Resolution of this question depends, in part, on the definition of "transfer" for this purpose.

One approach is to define a transfer solely by reference to the relevant contract – in other words, the provisions of the agreement that characterize the conditions imposed on the transfer. For example, this approach could start from the premise that outright transfers are not subject to the proposal, but continuing licensing are subject to the proposal. A conclusive determination as to either, however, would be determined based on the terms of the agreement that effected the transfer, whether those terms are written or implied by the actions of the taxpayer and the CFC. In addition to the administrative difficulty inherent in this fact-based approach, it could also provide an incentive to taxpayers to transfer as much intangible property possible to CFCs –

[604] Under the temporary cost sharing regulations, compensable "platform contributions" includes services that are provided within the cost-sharing arrangement. Temp. Treas. Reg. secs. 1.482-7T(c)(1), (c)(3), (c)(5) *Example* (2), and 1.482-7T(k)(2)(ii)(H). Thus, it is not necessary that there be an explicit transfer of intangible property. It may be appropriate for legislation to address similar migrations of value in which there are no explicit or identifiable transfers of intangible property. *Cf.*, *Hospital Corp. of America v. Commissioner*, 81 T.C. 520 (1983) (presenting an affiliate with the opportunity to negotiate and perform a contract is not the same as transferring a legally enforceable right under sections 351 and 367; however, the affiliate had been provided compensable services, and the court imposed a section 482 services adjustment).

through structured transactions designed to mitigate income recognition on the outbound transfer – prior to the effective date, with the goal of avoiding application of the proposal.

Units of production.−A transfer could be defined at a level reflecting its most basic component, such that each specific use of intangible property in conjunction with the production of each unit of the good or service reflects a distinct transfer of the underlying intangible property. With this definition, any pre-effective date transfers (whether the method of transfer was by multi-year agreement or by outright transfer) give rise to post-effective transfers for purposes of the subpart F proposal as long as units continue to be produced. This approach facilitates administration of the proposal by basing a transfer of intangible property solely on the use of that intangible property by the CFC, which should be a readily ascertainable and objective fact. It may have the added benefit of precluding the development of strategies which avoid the intent of the subpart F proposal based on the conditions and form of the transfer prior to the effective date.

Inherent in this approach is that the CFC is subject to effective tax rate and excessive return testing during the useful life of the transferred intangible. It is not clear whether the CFC is subject to testing once the intangible property has been disposed of, is no longer in use, or has reached the end of its useful life. If a CFC that receives a covered transfer is permanently tainted, such that this element of the test is irrevocably satisfied, the proposal may achieve its objective of reducing the financial incentive to shift income to low-tax jurisdiction through outbound transfers of intangible property. In addition, the risk of a permanent taint may provide an incentive to taxpayers to divert intangible property away from low-tax jurisdictions, an objective of the proposal.

Cost sharing arrangements.−Transfers made in conjunction with cost-sharing arrangements present a unique issue. With cost sharing, an important "use" of the transferred intangible property may be as the platform from which the next generation is developed. For example, with respect to the transfer of Version 1.0 intangible property, the buy-in agreement might entitle the CFC to (1) the foreign "make and sell" rights during the useful life of Version 1.0, (2) the right to develop Version 2.0 from Version 1.0, and (3) economic ownership of the foreign rights to Version 2.0. To the extent that the CFC avails itself of the intangible property by making and selling Version 1.0 products, the use of Version 1.0 in production subjects that transfer to the subpart F proposal. On the other hand, upon the successful development of Version 2.0, it is unclear whether production of Version 2.0 products should be considered as a successor to the use of Version 1.0 intangible property.

One approach is to deem the transfer of Version 1.0 as being made with respect to each Version 2.0 product manufactured on the theory that Version 1.0 is inherently incorporated in Version 2.0. While the nexus between Version 1.0 and Version 2.0 may be sufficient to warrant this approach, it is unclear whether it should also continue in perpetuity as subsequent versions (3.0, and so forth) are developed. Arguably, a covered transfer that the proposal treats as continuing in perpetuity during the useful life of any Version 1.0 progeny, without regard to the actual useful life or usefulness of Version 1.0, mitigates the financial incentive to cost share intangible property development. On the other hand, if the proposal does not specify how to treat subsequently developed versions, determining, on a case-by-case basis, whether a subsequently developed version has sufficient nexus to the original covered transfer to be considered a successor to the covered transfer may impose significant administrative burdens on both taxpayers and the IRS.

Limited to intangible property that is transferred from the United States

The subpart F proposal applies only to intangible property that is transferred from the United States. As a result, taxpayers may perform more R&D activities outside the United States at their CFCs from inception to avoid its application. In addition, CFCs may hire related U.S. affiliates to perform contract R&D services on their behalf more frequently.

Intangible property developed by a CFC.–Income from intangible property developed by a CFC is outside the scope of the subpart F proposal. Accordingly, CFC income derived from intangible property developed and owned by a CFC organized in a low-tax jurisdiction is not subject to excessive return testing unless predicated on some other intangible property transfer to the CFC by a related U.S. person (as discussed above).

Within a taxpayer's affiliated group, R&D is often performed in the United States. Contract R&D services are sometimes provided to a CFC pursuant to an R&D service agreement or a cost-sharing arrangement. The CFC compensates the taxpayer for services performed at an arm's-length mark-up (typically within the range of five percent to 10 percent).[605] Thus, the taxpayer commits its U.S.-based intellectual capital resources to the R&D effort, but the CFC takes the financial risk on the R&D project, and therefore is entitled to ownership (as well as any above-normal returns) if the R&D efforts are successful. If, instead, these services are provided in the context of a cost-sharing arrangement, the only benefit to the taxpayer from the commitment of its R&D resources is the right to exploit the new intangible property consistent with the rights assigned to the taxpayer in the cost-sharing arrangement (e.g., the taxpayer is assigned the right to exploit the U.S. market). In addition, the taxpayer may be entitled to claim the R&D credit provided by section 41 under such contract R&D arrangements. In exchange, the taxpayer shares in the development cost pro rata, based on the reasonably anticipated benefits of each cost-sharing participant (e.g., the taxpayer's share is based on the expected U.S. sales as a percentage of expected total sales). In either case, under present rules there is no transfer of intangible property to the CFC under the R&D services agreement or cost-sharing arrangement because the CFC owns the output that results from the contract R&D services from inception.

There are also important nontax considerations in selecting the physical location for R&D, as well as the legal entity that funds and bears the risk of R&D. For example, access to, and retention of, qualified scientists may be important reasons to locate R&D activities in the United States. In addition, because the U.S. GAAP financial statement tax "benefit" from any loss that results from R&D performed in a low-tax jurisdiction that is not successful is recorded as a detriment, taxpayers may not make a wholesale shift of R&D to low tax jurisdictions. The

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[605] See, e.g., *Westreco v. Commissioner*, T.C. Memo 1992-561 (fees, provided in a contract research agreement between related parties, in the amount of 7.5 percent on the first $350,000 of costs, five percent with respect to the next $1,150,000 of costs, and 3.5 percent on costs over this amount, were comparable to fees between uncontrolled corporations). However, an arm's-length result for any particular contract R&D agreement would depend on the specific terms of that contract R&D arrangement.

detriment reflects the value of the foreign losses computed at the low tax rate, which is less than the value of those same losses computed at the 35-percent U.S. statutory tax rate. Therefore, taxpayers are generally selective when identifying projects for foreign development, choosing only those projects with the highest likelihood for success. Nonetheless, taxpayers may increase foreign R&D activities by CFCs to avoid current taxation under the subpart F proposal.

Intangible property acquired outside the United States.–Under current U.S. tax rules, there are several reasons why taxpayers acquiring intangible property, directly or indirectly, may consider making the acquisition through a CFC.[606] First, the 35-percent U.S. tax rate imposes a relatively high cost on income earned from intangible property in comparison to the tax liability that would be incurred if the same income were earned in another jurisdiction, most of which now have lower statutory tax rates on business income.[607] Second, the United States imposes tax on any built-in gain when intangible property is transferred outside the United States, which makes even temporary ownership of newly acquired intangible property a potentially costly decision.[608] Third, the lock-out effect of deferral[609] means that companies may have funds available offshore to invest in such acquisitions. Indeed, foreign acquisitions are often an important use of CFC cash. The subpart F proposal adds another consideration to this list, and favors acquiring certain intangible property through a CFC.

Treaty considerations

The subpart F proposal requires certain active business income earned by a CFC to be taxed currently in the United States to the United States shareholder. To the extent that the CFC is organized in a jurisdiction with which the United States has a tax treaty, some treaty partners may argue that the proposal is inconsistent with the obligations established by the treaty.

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606 If a direct acquisition includes the right to use certain intangible property in the United States, the CFC may be treated as holding an investment is U.S. property for purposes of section 956.

607 For the corporate income tax rates of OECD member countries, see the OECD Tax Database, Table II.1, available at http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#cci.

608 For example, on January 1, a U.S. company acquires the rights to a molecule in an early stage of development that has promise as a potential cure for chicken pox. The molecule is purchased for $100, its fair market value on that date. On February 1, the company discovers that the drug stimulates hair growth. On March 1, the company transfers the rights to the molecule to newly formed CFC organized in the country that does not impose a tax on business income. The U.S. company is subject to U.S. tax based on the built-in gain (the fair market value of a molecule that potentially cures baldness less $100) under section 367(d). As a result of the discovery on February 1, the acquisition of the molecule should not be considered an exact comparable to the outbound transfer of the molecule, despite the proximity of the transfer dates.

609 Once income has been earned offshore in a lower tax jurisdiction, it can be more profitable to reinvest offshore rather than repatriate the after-(foreign)-tax earnings. This referred to as a "lock-out effect." This arises because after-tax returns on a foreign investment are generally higher than the after-tax returns the taxpayer can obtain on a similar investment after the funds are repatriated to the United States because the repatriated funds will be subject to residual taxation by the United States before they can be invested domestically. See generally, John Graham, Michelle Hanlon and Terry Shelvin, "Barriers to Mobility: The Lockout Effect of US Taxation of Worldwide Corporate Profits," *National Tax Journal* (forthcoming), available at http://cber.utk.edu/confpapers/Gra_Han_She.pdf.

Source and residency taxation

Under the U.S. Model Tax Treaty, the primary right to tax income attributable to intangible property is granted to the owner's country of residence.[610] This granting of primary rights is accomplished by operation of provisions commonly found in bilateral tax treaties (which typically eliminate or reduce withholding taxes on royalties paid) in conjunction with the deductibility of royalties in the country of exploitation. Thus, even though the intangible property owner treats the source of a royalty as the country of its exploitation for U.S. tax purposes, income arising from the intangible property may be subject to little or no tax in that jurisdiction. The income that remains after payment of the royalty is generally considered business profits, which reflect a return on the transferee's contributions. In general, the United States does not tax the business profits of a company that is a resident of a treaty partner, even where that company is controlled by a U.S. person, unless that foreign treaty resident derives income that is effectively connected with a permanent establishment in the United States.

While treaties generally allocate the primary right to tax business profits to the source country, this general rule does not preclude concurrent (but residual) taxation (i.e., the imposition of residual U.S. tax in excess of the statutory tax rate in the country of exploitation for the year that the income is earned) by the residence country provided that a foreign tax credit is available to avoid double taxation. The contemporaneous expansion – both within and outside of the United States – of residence taxation of specific types of undistributed earnings is consistent with the notion of the widespread acceptance by U.S. treaty partners of concurrent (but residual) taxation of subpart F type income, and that these provisions are not viewed by treaty partners as repudiating the intent or the terms of tax treaties. The OECD concurs with this view.[611]

Concurrent (but residual) taxation by the United States has been limited to situations predominantly involving income from: (1) insurance or reinsurance of U.S. risks; (2) passive income; (3) "the purchase and sale of property without any appreciable value being added to the product by the selling corporation;"[612] and (4) the performance of certain services outside the CFC's country of incorporation (the latter two of which are referred to as the "base company" rules). Arguably, the first two types of income are each passive in nature, while base company services income is active because value is generated by the bona fide performance of services. Base company sales income may be active, if value is being added to the property that is purchased. In this way, taxing active income currently under the subpart F proposal is within the

[610] See United States Model Income Tax Convention, November 15, 2006, Article 12 (Royalties).

[611] OECD, Commentaries on the Articles of the Model Tax Convention (2008), Article 1, par. 23. ("Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognized as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities.")

[612] H.R. Rep. No. 87-1447 (1962): p. 62, reprinted in 1962-3 C.B. 405. See also S. Rep. 87-1881 (1967): p. 84, reprinted in 1962-3 C.B. 707. The Conference Report refers to foreign base company sales income as arising when the property sold was neither manufactured in, nor sold for use, consumption or disposition in, the country in which the controlled foreign corporation is organized. H.R. Conf. Rep. No. 87-2508, (1962): p. 30 reprinted in 1962-3 C.B. 1129.

established framework of concurrent (but residual) U.S. taxation because, as with the proposal, in some circumstances active income is subject to concurrent (but residual) U.S. taxation under present law.

On the other hand, residual active services income is concurrently taxed by the United States when it is presumed, based on the fact that the services are performed outside the country in which the CFC is organized, as being derived from a largely artificial arrangement. A similar construct applies to base company sales income, but the applicable provisions turn on whether activities have been shifted outside the country in which the CFC is organized to achieve a lower tax rate on selling activities.[613] Under the subpart F proposal, concurrent (but residual) U.S. taxation may apply to active income even where the CFC makes bona fide, substantive, contributions to the production of active business profits in the same country in which it is organized. Accordingly, some treaty partners may be concerned that the subpart F proposal conflicts with negotiated treaty rights to the extent that it is viewed as the residence jurisdiction "taking away [the source jurisdiction's] right to effectively grant tax holidays to foreign investors"[614] or attract investment through low tax rates. However, the U.S. has never sanctioned tax sparing agreements in treaties (i.e., provisions that preserve tax incentives granted by lower-income jurisdictions to induce foreign direct investment by limiting residual taxation of earnings upon repatriation to a higher-income jurisdiction) and tax sparing agreements have been the impediment to concluding treaty negotiations.

<u>Tax administration</u>

<u>In general</u>

The proposal does not include any provisions for penalties or reporting. The proposal may require taxpayers to adopt new record keeping practices to identify and track each transfer of intangible property from the United States that could potentially result in a subpart F inclusion for an excessive return. In many instances, such transfers are documented in contracts, as the contracts help ensure the deductibility of royalties or other forms of compensation paid for the use of intangible property and also support profit allocations for transfer pricing purposes. However, as a practical matter, the level and detail of documentation varies by taxpayer. In addition, if the intangible property covered by the proposal is defined broadly, there may be some intangible property transferred to CFCs without documentation. The proposal presents administrative challenges to the IRS as well, as the IRS is required to examine taxpayer self-assessment of subpart F income from excessive returns.

For example, assume a taxpayer encounters production problems at its low-tax CFC manufacturing facility as it starts producing a new biologic drug on a commercial scale. To resolve these problems, the taxpayer sends a group of scientists from the U.S.-based pilot plant. Over the course of a week, the scientists use know-how previously developed at the pilot plant to

[613] H.R. Rep. No. 87-1447 (1962): p. 62; see also S. Rep. 87-1881 (1967): p. 84.

[614] Reuven S. Avi-Yonah, "International Tax as International Law," *Tax Law Review* 57 (2004): pp. 483, 489.

resolve production problems, and in the process, this know-how (which is intangible property) is informally conveyed to the local operations team. Nonetheless, there may not be a contract between the CFC and the taxpayer that identifies and tracks the valuable information imparted from the scientists to the CFC during that week. Further, the taxpayer may not even be aware that the trip had potential significance under the proposal.

However, implicit in the proposal may be the expectation that, despite some increase in compliance necessary to accurately report subpart F income from an excessive return – including, possibly, the identification and tracking of previously informal transfers of intangible property – current taxation of an excessive return will reduce transfers of intangible property from the United States, resulting in a net decrease in the aggregate administrative burden.

Information asymmetry

The proposal resorts to subpart F as the principle mechanism for minimizing factual disputes in addressing the issue of excessive income shifting, rather than relying on transfer pricing adjustments under section 482. Use of subpart F permits the proposal to operate mechanically, and function as an antiabuse provision without the labor-intensive prerequisite of finding an abusive transaction. Instead, the proposal posits that, as a policy matter, (based on administrative experience and studies), that excessive income shifting is typically accompanied by the presence of: (1) a low effective foreign tax rate; (2) a relatively high ratio of income to physical assets or other measures of investment; and (3) intangible property transfers from the United States. As a result, taxpayers cannot avoid an income inclusion under subpart F by proving that there is no actual excessive income shifting, nor any intent to shift excessive income. The effect is to treat dissimilar taxpayers the same, such that some taxpayers with legitimately high rates of return are taxed currently as if they had engaged in excessive income shifting.

However, the difficulties that the IRS currently faces in transfer pricing disputes due to information asymmetry (i.e., the fact that the taxpayer inherently has more complete knowledge of its own facts than does the IRS) may continue under the proposal. While the proposal can be structured with observable, objective criteria for determining the effective foreign tax rate and what constitutes an excessive return, taxpayers control information regarding transfers of intangible property. Further, as demonstrated by the example above, taxpayers may not have adequate controls in place to identify and document information regarding formal and informal transfers of intangible property.

On the other hand, the information that must be ascertained by the IRS during an audit – whether there has, or has not, been a transfer of intangible property by a U.S. person from the United States – is binary in nature. In some instances, this may reduce the level of intervention necessary to determine if a taxpayer has appropriately excluded excessive returns identified at CFCs with low effective tax rates on the basis that there was no covered transfer.

Opponents contend that providing taxpayers with the opportunity to establish that their circumstances do not evidence excessive income shifting (i.e., that the taxpayer is in compliance with the arm's-length standard) is necessary to ensure a more equitable approach since the proposal does not distinguish between industries or take into account the diverse rates of return typically earned by different industries. Without such opportunity, industries with traditionally high rates of return could find that the industry, as a whole, is disproportionately subject to the proposal's current taxation on excessive returns when compared to other industries.

Prior Action

No prior action.

5. Limit shifting of income through intangible property transfers

Present Law

Pricing for transfers of intangible property between related persons

Within a group of related entities,[615] there are often no market pressures that impose market pricing on transactions between the related parties, and goods and services are transferred between related parties at self-derived prices. Absent transfer pricing rules, the lack of external market forces would permit multinational groups to shift income in any manner they choose among group members. Thus, the United States has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a related foreign company through aggressive transfer pricing that does not reflect an arm's-length result. Similarly, the domestic laws of most U.S. trading partners include rules on transfer pricing.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. In 1986, Congress added an additional test for transactions resulting in the transfer of intangible property, which provides that the income with respect to any transfer (or license) of certain intangible property to a related person must be commensurate with the income attributable to the intangible property. Section 367(d) provides a related rule under which compensation, in the form of an imputed royalty stream, is required for an outbound transfer of intangible property in the context of an otherwise nontaxable reorganization transaction.[616]

[615] The term "related" as used herein refers to relationships described in section 482, which applies to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

[616] For additional discussion of the methods and rules under section 482 see VI.F.4 (Tax Currently Excess Returns Associated with Transfers of Intangible Property Offshore) in this document.

Methods of transferring intangible property

A U.S. person that develops or purchases intangible property generally can make that intangible property available to a related person (typically, a foreign affiliate) in four ways. The first is through an outright transfer of all substantial rights in the intangible property, either by sale or through a non-recognition transaction (for example, a capital contribution of the intangible property to the affiliate in an exchange that meets the requirements of section 351, or an exchange made pursuant to a plan of reorganization that is described in section 361). The second is through a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate.[617] The third is the provision of a service using the intangible property, rather than a direct transfer of the property.

In the fourth, intangible property is made available through a cost-sharing arrangement. In a typical cost-sharing arrangement, a U.S. company and one or more foreign affiliates make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable product or service. The U.S. company makes available all, or a substantial portion, of the rights to use and further develop existing intangible property, and the foreign affiliate (typically organized in low-tax jurisdiction) generally contributes cash. The arrangement provides that the U.S. company owns legal title to, and all U.S. marketing and production rights in, the developed property, and that the other party (or parties) owns rights to all marketing and production for the rest of the world.[618] Reflecting the split economic ownership of the newly developed asset, no royalties are paid between cost sharing participants when the product is ultimately marketed and sold to customers. However, the U.S. company receives a buy-in payment[619] (such as periodic intercompany royalties or a

[617] The significance of the retained residual rights depends, in part, on the length of the license term as well as any restriction (express or implied by the taxpayer's conduct) on any potential competing use of the retained rights in the area of use belonging to the licensee.

[618] There are numerous variations on this basic description of a typical cost-sharing arrangement. For example, another approach may allocate cost sharing (and, therefore, the profit entitlement thereto) by product or by region (e.g., the U.S. cost-sharing participant may be allocated North America, while the foreign cost-sharing participant is allocated the rest of the world, or the U.S. cost-sharing participant is allocated products A, B and C, while the foreign cost-sharing participant is allocated products X, Y, and Z). In addition, any participant in a cost-sharing arrangement may contribute its existing intangible property to a cost-sharing arrangement (e.g., if a foreign subsidiary owns the rights to product X, the foreign subsidiary and its U.S. parent may cost share the next generation of product X).

[619] Present regulations refer to "buy-in payments" as "PCT payments," (i.e., payments for platform contribution transactions). Temp. Treas. Reg. sec. 1.482-7T(b)(ii). The more common term, "buy-in payment," is used herein. The buy-in payment eliminates the benefit of expense deductions for research and development ("R&D") previously performed in the United States; amounts received in excess of previously deducted R&D expenses incurred should represent the present value of the intangible property transferred, discounted for the risk assumed by the transferee. The ongoing cost-sharing payments offset any deductions that the recipient of such payment takes for post-buy-in R&D activities. Such ongoing cost sharing does not, however, include compensation for the expected above normal return on any products that may result from that R&D.

lump sum payment at the outset) from the other cost-sharing participant with respect to its "platform" contribution.[620]

The mechanism used for transferring intangible property to a foreign affiliate frequently dictates whether the authority for determining the compensation received by the U.S. person in the transaction is under section 482 or section 367(d). Generally, a license or a sale of intangible property, or the provision of a service that uses intangible property, is subject to section 482. An exchange of intangible property in connection with certain nonrecognition transactions is subject to section 367(d), which overrides the general nonrecognition rules of sections 351 and 361 to require that the transferor of intangible property include imputed income from annual payments over the useful life of the intangible, as though the transferor had sold the intangible (at whatever stage of development it is, from an entirely undeveloped idea through, and including, a completely developed and exploitable item of intangible property), at times in exchange for contingent payments. The appropriate amounts of those imputed payments are determined under section 482 and the regulations thereunder. Transfers of foreign goodwill or going concern value are specifically exempt from the income recognition provisions of section 367(d).[621] With respect to cost-sharing arrangements, specified rights to existing intangible property can be transferred to other cost-sharing participants either through a sale or a license.[622]

<u>Application of section 482 principles to unidentified intangible property</u>

For purposes of sections 482 and 367(d), "intangible property" is defined by reference to section 936(h)(3)(B) and means any: (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item. The term "intangible property" contemplates that any such item must have substantial value independent of the services of any individual.[623]

A definition of workforce in place is set forth in the regulations under section 197, which define it as a separate asset that includes "the composition of a workforce (e.g., the experience, education, or training of a workforce), the terms and conditions of employment, whether

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[620] In this context, a "platform contribution" is any resource, capability, or right that the U.S. company has developed, maintained or acquired outside of the cost-sharing arrangement, that is reasonably anticipated to contribute to the development of cost-shared intangible property. Temp. Treas. Reg. sec. 1.482-7T(c)(1). Implicit in the definition of a platform contribution is that the resource, capability, or right is made available through the cost-sharing arrangement.

[621] Temp. Treas. Reg. sec. 1.367(d)-1T(b).

[622] A taxpayer might choose a fixed lump sum form of payment if it has net operating losses in the United States that would offset the income from the transfer of the intangible property. In the absence of net operating losses, taxpayers might choose a contingent form of periodic payments.

[623] Treas. Reg. sec. 1.482-2A(d)(3)(i).

contractual or otherwise, and any other value placed on employees or any of their attributes."[624] Prior to the promulgation of these regulations,[625] the Tax Court held that workforce in place "is not separate and distinct from going concern value" because it is not a wasting asset.[626] Later, following the Supreme Court decision in *Newark Morning Ledger*, the Court of Appeals in *Ithaca* noted that it was no longer appropriate to deny a deduction on the basis on an intangible asset's resemblance to the classic conception of goodwill or going-concern value. However, the decision of the Tax Court was affirmed, as the useful life of the workforce in place was not ascertainable. The 2008 cost sharing regulations treat workforce in place as separately compensable if the U.S. parent's workforce in place is reasonably expected to contribute to the development of cost-shared intangibles; in this situation, the workforce in place is considered a platform contribution for which the foreign subsidiary must compensate the U.S. parent.[627]

Valuation methods

The Treasury regulations under section 482 require that the "arm's-length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's-length result."[628] Taxpayers must use not only the best method, but also the most reliable application of that method.[629] "Aggregation" and "realistic alternative" are valuation concepts prescribed by the transfer pricing regulations. These valuation methods are to be used when they provide the most reliable measure of an arm's-length result. When these methods are used in those circumstances, then the taxpayer will have used the best method as is required by the transfer pricing rules. As with all section 482 rules, this principle of reliability as articulated in section 482 regulations is applied to the valuation of outbound intangible property transfers under section 367(d).[630]

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[624] Treas. Reg. sec. 1.197-2(b)(3).

[625] Section 197 was enacted on August 10, 1993, Pub. L. No. 103-66. Treas. Reg. sec. 1.197-2(b)(3) was issued on January 20, 2008. T.D. 8865, 2000-1 C.B. 589.

[626] *Ithaca Industries v. Commissioner*, 97 T.C. 253, 271-272 (1991), 17 F.3d 684 (4th Cir. 1994), cert. denied, 513 U.S. 821 (1994). *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993). See also *First Pennsylvania Banking & Trust Co. v. Commissioner*, 56 T.C. 677, 690 (1971) (workforce in place "formed a part of the going-concern value which was purchased").

[627] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(vii)(B), *Example* 1, part (ii).

[628] Treas. Reg. sec. 1.482-1(c)(1).

[629] *Ibid*.

[630] See also, Tech. Adv. Mem. 200907024 (February 13, 2009), p. 14 (hereafter "TAM 200907024") The taxpayer contended that separate contracts between the taxpayer and a large number of foreign agents in numerous countries must be valued separately for purposes of applying section 367(d) and attributed the residual value of the businesses to non-compensable foreign goodwill or going concern value. The IRS rejected this position, stating that it was "more reliable to determine the arm's length consideration for that transfer of a [network of] contracts by considering the separate contracts 'as a whole' because they are 'so interrelated.'" A similar issue is presented in a petition filed with the Tax Court by First Data Corporation, challenging an adjustment by the IRS on this issue. *First Data Corp. v. Commissioner*, No. 007042-09 (T.C. filed Mar. 20, 2009).

Aggregation

Treasury regulations under section 482 provide that multiple transactions may be considered in the aggregate if doing so provides the most reliable means of determining the arm's-length consideration for the related-party transaction.[631] For example, assume that a pharmaceutical company makes ten patents (each of which is a critical, unique component in the manufacture of its blockbuster drug, ABC) available to other cost-sharing participants through a cost-sharing arrangement. Those patents could be valued, for purposes of determining an appropriate buy-in payment, on either an asset-by-asset approach, or an aggregation approach. The taxpayer may take the position that an arm's-length result is achieved by valuing intangible property on an asset-by-asset basis; in this example, each individual patent may have only marginal value when considered in isolation. When considered in aggregate (particularly in light of the success of the ABC drug), the valuation may be materially higher than the sum of the individual patents.

Realistic alternative

The realistic alternative principle is reflected in Treasury regulations, which provide that the Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance, but that the Commissioner may also consider the alternatives available to the taxpayer in determining whether the terms of the related-party transaction would be acceptable to an unrelated-party taxpayer faced with the same alternatives and operating under comparable circumstances.[632] As with specified methods, unspecified methods should reflect a consideration of the realistic alternatives to the actual transaction in connection with a transfer of intangibles.[633] Similar rules apply with respect to unspecified methods for transfers of tangible property,[634] cost-sharing arrangements[635] and intercompany services.[636] Although the examples in the regulations emphasize the analysis of available, but not undertaken, internal transactions entirely within the related-party group,[637] the realistic alternative principle is not limited to such transactions.[638]

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[631] Treas. Reg. sec. 1.482-1(f)(2)(i), in conjunction with the best method rule of Treas. Reg. sec. 1.482-1(c)(1).

[632] See, e.g., Temp. Treas. Reg. sec. 1.482-1T(f)(2)(ii).

[633] Treas. Reg. sec. 1.482-4(d)(1).

[634] Treas. Reg. sec. 1.482-3(e)(1).

[635] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iii).

[636] Treas. Reg. sec. 1.482-9 (h). See also, Treas. Reg. sec. 1.482-1(d)(3)(iv)(H) and 1.482-3(b)(2)(ii)(B)(8).

[637] See, Treas. Reg. secs. 1.482-1(f)(2)(iii)(B) *Example;* 1.482-4(d)(2)(ii) *Example;* and 1.482-3(e)(2) *Example;* and Temp. Treas. Reg. secs. 1.482-7(g)(2)(iv)(B) *Examples.*

[638] See, Treas. Reg. sec. 1.482-9(h) *Example* (where the Commissioner determines that an intragroup service transaction involving password-controlled internet access to software is comparable to a similar arm's-length

Recent litigation

Both the identification of intangibles and the appropriate valuation of such intangibles were in dispute in *Veritas v. Commissioner.*[639] The issue was the adequacy of the lump-sum payment made by a cost-sharing participant for use of the intangibles the taxpayer had made available through a cost-sharing arrangement. The taxpayer's Irish affiliate made a buy-in payment of $118 million as a royalty for the use of a full-range of pre-existing intangible property. The royalty was determined based on internal comparable transactions, in which the taxpayer had licensed the same intangible property to unrelated parties. However, none of the internal comparables licensed the same full-range of rights as were bundle together and made available under the cost-sharing arrangement, although collectively the agreements involved essentially the same intangible property. The IRS challenged the comparability of the internal transactions on which the taxpayer based its determination of the transfer price, contending that the rights granted in of each third-party license were materially narrower than those made available through the Irish affiliate through the cost-sharing arrangement. The IRS also argued that the most reliable method for valuing the bundle of rights that were transferred was as an aggregation of rights. Further, the IRS also contended that the taxpayer should have been compensated for the transfer of existing goodwill, going-concern value, and workforce in place to the Irish affiliate.

Description of Proposal

The proposal states that it clarifies that the definition of intangible property for purposes of sections 367(d) and 482 includes workforce in place, goodwill and going concern value. The proposal also states that it clarifies that in a transfer of multiple intangible properties, the Commissioner may value such properties on an aggregate basis where doing so achieves a more reliable result. Finally, the proposal states that it clarifies that the Commissioner may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

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

Analysis

In recent years, transfer pricing audits and proposed adjustments with respect to transfers of intangible property have emphasized two particular issues. The first is the adequacy of the buy-in payment for existing intangible property made available to related affiliates pursuant to cost-sharing arrangements; these transfers are typically subject to section 482.[640] The second is

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transaction involving the sale of, and uncontrolled access to, software through a download or the transfer of a diskette, the similar arm's-length transaction may be considered for purposes of determining whether the intragroup transaction achieves an arm's-length result*).*

[639] 133 T.C. No. 14 (December 10, 2009).

[640] Cost-sharing buy-in payments were designated as a Tier I compliance issue on April 5, 2007. See "*Industry Director Directive #1 on Transfer of Intangibles Offshore/ §482 Cost-sharing Buy-in Payment,"* LMSB

the adequacy of compensation paid by a CFC for intangible property transferred in connection with recent outbound restructurings of U.S. manufacturing operations that preceded the expiration of the section 936 possessions credit rules; these transfers are typically subject to sections 367(d) and 482.[641] The proposal does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property. Instead, its scope is limited to addressing certain definitional and methodological issues that have arisen in IRS examinations of the value attributed to intangible property at the time it is transferred outside the United States.

Definition of intangible property

The proposal affirmatively answers the question of whether an outbound transfer to related-party of goodwill, going concern value, and workforce-in-place may require compensation. In casting the proposal as a clarification, the Administration continues to support the position it has taken in recent litigation and regulations that workforce in place, goodwill, and going concern value are intangible property listed in section 936(h)(3)(B) as "similar items."[642] On the other hand, taxpayers deny that compensation is required for any price is required goodwill, going concern value, and workforce-in-place under present law.

Control No: LMSB-04-0307-027, available at http://www.irs.gov/businesses/article/0,,id=169313,00.html. The IRS initiated the tiering of compliance issues in 2007 with the issuance of new Rules of Engagement for examiners to follow when investigating tax disputes involving large corporations. These Rules are intended, in part, to "promote consistent tax treatment between similarly situated taxpayers or cases." Part 4. Examining Process, Chapter 51. LMSB Examinations, Section 1. Rules of Engagement (April 1, 2007) (the "Rules") reprinted at "*IRS Unveils Rules of Engagement for Industry Issue Focus Approach to Compliance," Tax Notes Today,* 84-02, (April 30, 2007). The Rules prioritize specific compliance issues on a tiered basis according to prevalence across industry lines and the level of compliance risk presented. Tier I includes issues of high strategic importance that have a significant impact on one or more industries.

[641] Section 936 exit strategies were designated as a Tier I compliance issue on February 2, 2007. See "*Industry Director Directive on Section 936 Exit Strategies,"* LMSB Control No.: LMSB-04-0107-002, available at http://www.irs.gov/businesses/corporations/article/0,,id=167555,00.html; see also Notice 2005-21, 2005-1 C.B. 727. In a typical post-section 936 conversion, the U.S. taxpayer contributed mature Puerto Rican business operations to a CFC in exchange for shares in the CFC, or reincorporated a Puerto Rican subsidiary as a CFC in a non-taxable reorganization under section 368(a)(1)(F). These operations often consisted of property, plant and equipment, workforce in place and other assets physically located in Puerto Rico but owned by a U.S. section 936 company. The 936 company either owned, or had the right to use, intellectual property comprising both foreign and domestic rights, and often exploited both U.S. and rest of world markets. As the benefit of the section 936 possessions credit came to an end, these operations were transferred offshore in order to replace the section 936 tax credit with deferral benefits. For a discussion of the conversion of section 936 companies to CFCs, legislative proposals related to the expiration of section 936, and broader tax matters related to the U.S. possessions, see Joint Committee on Taxation, *An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options* (JCX-24-06), June 23, 2006.

[642] See sec. 936(h)(3)(B)(vi); see also Treas. Reg. sec. 1.482-4(b)(6), which states that "an item is considered similar to those listed … if it derives its value not from its physical attributes but from its intellectual content or other intangible properties."

While the proposal states that it is intended to clarify present law, some commentators have expressed the view that the proposal represents a significant change to present law.[643] In addition, the U.S. Tax Court rejected this characterization, stating that the Administration had, when it made the same proposal in 2009, "proposed to change the law."[644] Although that question may have relevance to the resolution of disputes under present law, it seems likely that the proposal, if enacted, would establish that the compensable proportion of the value inherent in many outbound transfers of intangibles would be larger under the proposal than the amount believed by many to be compensable under present law.

Goodwill and going concern value

With regard to goodwill and going concern value, IRS audit disputes concern the threshold treatment of these items as intangibles, the scope of the exception under section 367(d) for foreign goodwill or going concern value, and the extent to which the exception under section 367(d) should be imputed to section 482. Questions in this regard include how to distinguish foreign goodwill or going concern value from U.S. goodwill and going concern value, where both are transferred,[645] and whether foreign goodwill or going concern value is an attribute of foreign operations that develops over time. The IRS asserts that foreign goodwill or going concern value has no value at the start-up of foreign operations.[646]

Taxpayers have contended that the exceptions from compensation under section 367(d) must be imputed to transfers of intangibles under section 482 (even though this exception is not referenced in the section 482 statute, legislative history, or the regulations) on the basis that sections 482 and 367(d) must be read together, because the transactions to which they apply are economically similar and should receive similar tax treatment. Commentators have also stated that adding goodwill and going concern value to the definition of intangible property under section 936(h)(3)(B) obsoletes the exception for foreign goodwill or going concern value set forth in Temp. Treas. Reg. sec. 1.367(d)-1T(b).[647] This conclusion is predicated, however, on

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[643] See, e.g., Molly Moses and Rita McWilliams, "*Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles," BNA Daily Tax Report* (May 18, 2009) (hereafter, "*Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles"*).

[644] *Veritas v. Commissioner*, 133 T.C. No 14, 32, 2009 WL 472360 (December 10, 2009). The court concluded that "there was no explicit authorization of the [IRS's…] inclusion of workforce in place, goodwill, or going-concern value" in calculating the allocation to the buy-in payment. It is unclear whether the IRS will appeal this decision.

[645] See Molly Moses and Rita McWilliams, "*Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles.*"

[646] See, e.g., "*LMSB Procedures for Program Action Cases (PACs) on Tax Return Preparers,"* LMSB-04-0108-001 (February 13, 2008) reprinted at *Tax Notes Today* 36-42, (February 22, 2008): *Background* ("The definition of foreign goodwill or going concern value requires a business operation conducted outside of the United States."); see also, "*Coordinated Issue Paper Addresses Cost-sharing Arrangement Buy-In Adjustments*," section III.E.1., LMSB-0400907-62 (September 27, 2007), available at http://www.irs.gov/businesses/article/0,,id=174320,00.html (hereafter, "2007 IRS *Coordinated Issue Paper"*).

[647] See, e.g., James P. Fuller, "U.S. Tax Review," *Tax Notes International 54* (June 1, 2009): p. 776.

the position that specifically identifying goodwill and going concern value as intangible property under section 936(h)(3)(B) is a change in law, rather than a clarification of present law, because only a change in the law would obsolete the (earlier-promulgated) regulation. The description of the proposal as a clarification of (and not as a change to) present law suggests that the proposal is not intended to revoke the exception. In any event, the question could easily be addressed by incorporating an explicit exception for transfers of foreign goodwill or going concern value in the implementing legislation, if Congress wishes to preserve the exception.

Workforce in place

With regard to workforce in place, IRS audit disputes include both whether it is a "similar item" under section 936(h)(3)(B)(vi) and, if so, whether it is a component of goodwill or going concern value or a separately identifiable asset. Some taxpayers argue that, if it exists at all (as intangible property beyond its physical element), workforce in place is a component of goodwill and going concern value and, consequently, transfers of a foreign workforce in place are non-compensable under section 367(d).[648] In contrast, the IRS takes the position that any identifiable intangible with substantial value independent of the services of any particular individual is, by definition, not goodwill or going concern value.[649] Thus, any workforce in place (such as a research and development team that is made available − whether by transfer or through a service commitment − to a cost-sharing arrangement) that has substantial value independent of the services of any individual member of that workforce also has an intangible component that is distinct from goodwill and going concern value and compensable by the person for whose benefit it is used.[650]

Valuation issues

Overview

A second set of IRS audit issues arise in situations where the taxpayer agrees that a compensable intangible asset has been transferred offshore, but the IRS believes that the taxpayer has not applied the most reliable valuation technique.[651] In certain cases, for example, a taxpayer may believe that the most reliable method is to value intangible properties individually, on an asset-by-asset basis, without reflecting the enhanced value that may arise from their interrelationship. Where the IRS believes this method leads to unreliable results, the IRS

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[648] See, e.g., "*Audit Guidelines Related to Section 936 Conversion Issues, Attachment to Industry Directive on Section 936 Exit Strategies Audit Guidelines Related to Section 936 Conversion Issues,"* Step 2.d., available at http://www.irs.gov/businesses/corporations/article/0,,id=167559,00.html; see also, *2007 IRS Coordinated Issue Paper,* Section III.E.

[649] See sec. 936(h)(3)(B), flush language and Treas. Reg. sec. 1.482-4(b)(6); see also, *2007 IRS Coordinated Issue Paper*, Section III.E.1.

[650] See, e.g., *2007 IRS Coordinated Issue Paper*, Section III.E.3; "*Notice of Proposed Rulemaking and Notice of Public Hearing Section 482: Methods to Determine Taxable Income in Connection With a Cost-sharing Arrangement*," 2005-2 C.B. 625, 627 (hereafter *"2005 Proposed Section 482 CSA Regulations").*

[651] See, e.g., TAM 200907024.

disputes this asset-by-asset valuation approach. For example, the IRS may believe that the individual assets are so closely related that the individual pieces cannot be reliably valued on an asset-by-asset basis because the relevant intangible property is the complex comprised of the related parts.

In other cases, a taxpayer may assert a transfer price as an arm's-length result without also considering realistic alternatives to the transaction actually undertaken, such as the alternatives of making a product directly or outsourcing production. If the taxpayer fails to consider realistic alternatives, the IRS may assert that the taxpayer has not achieved an arm's-length result, because the taxpayer has assumed that an unrelated person at arm's-length would be willing to engage in a particular transaction, even if an available alternative would yield a greater economic return.[652]

Aggregation

The proposal confirms that the additional value that results from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, where doing so yields a more reliable result. This approach is consistent with Tax Court decisions in cases outside of the section 482 context, where collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate.[653] It is also consistent with the position taken in the recently issued cost-sharing regulations.[654]

The question presented in aggregate valuation cases is whether the enhanced value that, in some situations, results from the interrelation of identifiable intangible assets when they are grouped together can be attributed properly to those intangible assets. In the cost-sharing context, attributing the enhanced value to identifiable intangible assets results in a greater buy-in payment. If the enhanced value cannot be attributed to identifiable intangible assets, then the enhanced value is instead attributed to goodwill or going concern value. In the context of an outbound reorganization, the improper attribution of enhanced value to foreign goodwill or going

[652] See, e.g., *2005 Proposed Section 482 CSA Regulations,* p. 633.

[653] See, e.g., *Kraft Foods Co. v. Comm'r*, 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Comm'r*, 25 B.T.A. 281, p. 283 (1932) ("[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); *Massey-Ferguson, Inc. v. Comm'r*, 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).

[654] See Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iv) (if multiple transactions in connection with a cost-sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's-length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).

concern value may, in many cases, understate the actual value of the underlying intangible assets and result in inadequate compensation under section 367(d).[655]

In *Veritas v. Commissioner*, the Tax Court rejected the use of the aggregation by the IRS for purposes of valuing a transfer of intangible property. The Court noted that the use of the aggregation approach is permitted if it produces the most reliable means of determining the arm's-length consideration in related party transactions. The Court stated that the effect of aggregation was to value assets with short lives as if they had perpetual lives, as well as to value subsequently developed assets that were not transferred. As a result, the Court concluded that the aggregation approach did not, in that case, produce the most reliable result.[656]

There is no indication that the Court's decision in *Veritas* would have been different if the aggregation principle had been adopted by statute, rather than by regulations. The Administration may believe that taxpayers will be more likely to apply aggregation in the first place, and that IRS field agents may meet less resistance in applying the aggregation on audit if it is codified. However, the Court observed in *Veritas* that the effect of aggregation was to convert the license of intangible property into a sale, which would have dramatically increased the buy-in payment due from the Irish affiliate.[657] To the extent aggregation generally has the effect of converting a license into a sale and dramatically increasing the transfer price (in this case, the proposed adjustment exceeded $2 billion), taxpayers have a financial incentive to find that some other valuation method is the most reliable application of that method. This is the case whether aggregation is codified or not. Thus, in the absence of any challenge to the validity of the regulations, it is unclear why codification of aggregation is required to reinforce the existing regulation.

Realistic alternative

The proposal also codifies the realistic alternative principle with respect to intangible property. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. As a result, the existing regulations provide the IRS with the ability to determine an arm's-length price by reference to a transaction (such as the owner of an intangible property using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible property licensing the manufacturing rights and then buying the product from the licensee). In other words, the

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[655] In the context of section 367(d), taxpayers may also argue that requiring taxable compensation for the value of synergies among different intangibles is, in effect, to impose a tax on the value of the opportunity to conduct a business overseas, which, it is argued, has not previously been taxable under the principles of Section 367. See e.g., *Hospital Corp. of America v. Commissioner*, 81 T.C. 520, 590 (1983) (no section 367 ruling was required because the petitioner did not transfer property to its foreign affiliate when the petitioner presented the affiliate with an opportunity to enter into a contract); David R. Hardy, "*Assignment of Corporate Opportunities − The Migration of Intangibles," Tax Notes 100* (July 28, 2003) pp. 527, 532-539.

[656] 133 T.C. No 14, 40-41.

[657] *Ibid.*

realistic alternatives principle assumes that taxpayers act in an economically rational manner and uses this assumption as the basis for identifying transfer pricing that does not reflect an arm's-length result.

For example, if a taxpayer reports income of only $100 under one pricing method with respect to a transaction with a related party, but the IRS can demonstrate that a realistic alternative available to the taxpayer would have generated $1,000, all else being equal, the IRS will propose an adjustment. As the basis for its adjustment, the IRS will assert that the taxpayer's $100 of income is not an arm's-length result because unrelated parties, dealing at arm's-length, would not settle for less than $1,000. Otherwise, the taxpayer would be an irrational economic actor − a possibility that is rejected under basic economic and valuation theory.

In making its determination, the Commissioner evaluates the data provided by any available internal comparables (actual transactions between the taxpayer and third parties) and external comparables (actual transactions between unrelated parties), as well as information regarding the return to the property owner that could have been realized if the property owner had taken an alternative, but realistic, course of action in deploying the asset internally. If, when considering the data it is determined that the transfer price of a non-existent internal transaction differs materially from the transfer price of the actual controlled party transaction, the Commissioner may conclude that the taxpayer's transfer pricing of the actual transaction does not reflect an arm's-length result.

The "realistic alternative" principle was first adopted in final regulations issued in 1994,[658] following taxpayer-favorable court decisions. In *Bausch & Lomb,[659] for example,* the IRS disputed the comparability of the uncontrolled transactions proffered by the taxpayer, and argued that the Irish licensee of the "spin cast" method of manufacturing soft contact lenses was only entitled to a contract manufacturer return because its U.S. parent, the licensor, would not have been willing to pay an independent third party much more than the cost of producing the contact lenses itself. This so-called "make or buy" argument was rejected by the court, in part due to the preference given to one method over another in the then-existing regulations.[660] However, the example provided in the Treasury regulations (issued subsequently) to illustrate the realistic alternative rule for intangible property involves similar facts —specifically, the license of a proprietary process for making a product ("Longbond") from a taxpayer to its foreign subsidiary.[661] The example demonstrates that, in determining whether consideration paid with

[658] T.D. 8552, 1994-2 C.B. 93.

[659] 933 F.2d 1084 (2d. Cir. 1991).

[660] *Ibid.*, p. 1089.

[661] Treas. Reg. sec. 1.482-4(d)(2)(ii). See also Treas. Reg. sec. 1.482-1(f)(2)(ii)(B), *Example* (incorporating by reference the analysis in the example set forth in Treas. Reg. sec. 1.482-4(d)(2)(ii)).

respect to the license is arm's-length, the IRS may expressly consider (subject to the best method rule) the taxpayers alternative of producing and selling "Longbond" itself.[662]

OECD Transfer Pricing Guidelines (the "Guidelines") include the realistic alternative principle. For example, the OECD's general guidance for analyzing comparability under the arm's-length standard incorporates the realistic alternative concept, stating that "[i]ndependent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive."[663] Similarly, in the context of business restructurings, a recent OECD discussion draft concludes that the factors relevant to determining whether a transfer is an arm's-length transaction include "the options that would have been realistically available to the transferor and transferee at arm's-length, based on the rights and other assets of each at the outset of the restructuring, that determine the profit/loss potential of either."[664]

If the IRS believes that a taxpayer has not applied the best method or the most reliable application of that method, the realistic alternative is a tool available for testing what the transfer price would have been under different circumstances. To date, there are no legal decisions that analyze or discuss the realistic alternative provisions of the regulations, and no known controversy as to the validity of this regulation. Accordingly, it is unclear how codification of this regulation will advance administration of the transfer pricing cases or why codification is necessary to reinforce these particular existing regulations.

Prior Action

A similar proposal was included in the administration's fiscal year 2010 revenue proposal.

6. Disallow the deduction for excess nontaxed reinsurance premiums paid to affiliates

Present Law

Insurance companies in general

Subchapter L of the Code provides special rules for determining the taxable income of insurance companies. Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to tax at regular corporate income tax rates.

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[662] See also, Temp. Treas. Reg. sec. 1.482-7(g)(2)(iv)(B), *Examples*.

[663] *OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* I-12, ¶1.15.

[664] *OECD, Business Restructurings: Discussion Draft for Public Comment,* ¶66.

Property and casualty insurers

Under present law, the taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[665] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the NAIC.[666]

Deduction for unpaid loss reserves

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.[667] Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses). Present law provides for the discounting of the deduction for loss reserves to take account partially of the time value of money.[668] Thus, present law limits the deduction for unpaid losses to the amount of discounted unpaid losses. Any net decrease in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis.

The discounted reserves for unpaid losses are calculated using a prescribed interest rate that is based on the applicable Federal mid-term rate ("mid-term AFR"). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than five additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

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[665] Sec. 832.

[666] Sec. 832(b)(1)(A).

[667] Sec. 832(b)(3).

[668] Sec. 846.

Reinsurance premiums deductible

In determining premiums earned for the taxable year, a property and casualty company deducts from gross premiums written on insurance contracts during the taxable year the amount of premiums paid for reinsurance.[669]

Unearned premiums

Further, the company deducts from gross premiums the increase in unearned premiums for the year.[670] The company is required to reduce the deduction for increases in unearned premiums by 20 percent. This amount serves to represent the allocable portion of expenses incurred in generating the unearned premiums, so as to provide a degree of matching of the timing of inclusion of income and deduction of associated expenses.

Proration of deductions relating to untaxed income

In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns.[671] This rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

Treatment of reinsurance

In general

Present law includes a rule enacted in 1984 providing authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion.[672]

The rule permits the Treasury Department to make reallocations in related party reinsurance transactions. The rule was amended in 2004 to provide the Treasury Department with additional authority to allocate among the parties to a reinsurance agreement or to recharacterize income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and any other items related to the reinsurance agreement, or to make any other

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[669] Sec. 832(b)(4)(A).

[670] Sec. 832(b)(4)(B). Unearned premiums are generally those premiums received for insurance coverage in a future taxable year of the insurance company.

[671] Sec. 832(b)(5).

[672] Sec. 845. See Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060.

adjustment to reflect the proper source, character, or amount of the item.[673] In expanding this authority to the amount (not just the source and character) of any such item, Congress expressed the concern that "reinsurance transactions were being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons," and that "foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base."[674]

The rule also provides that if the Secretary determines that a reinsurance contract between insurance companies, whether related or unrelated, has a significant tax avoidance effect on any party to the contract, the Secretary may make an adjustment to one or both parties to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. The legislative history provides that in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, appropriate factors for the Treasury Department to take into account are (1) the duration or age of the business reinsured, which bears on the issue of whether significant economic risk is transferred between the parties, (2) the character of the business (as long-term or not), (3) the structure for determining potential profits, (4) the duration of the reinsurance agreement, (5) the parties rights to terminate and the consequences of termination, such as the existence of a payback provision, (6) the relative tax positions of the parties, and (7) the financial situations of the parties.[675]

Reinsurance premiums received by foreign persons

The United States employs a worldwide tax system under which U.S. persons (including U.S. citizens, U.S. resident individuals, and domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including nonresident alien individuals and foreign corporations) are taxed in the United States only on income that has a sufficient nexus to the United States.

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States.[676] Such income may be derived from U.S. or foreign sources. This income generally is taxed in the same manner and at the same rates as income of a U.S. person. For this purpose, deductions are allowed only if and to the extent that they are connected with the income that is effectively connected with the conduct of a trade or business within the United States. In addition, foreign persons generally are subject to U.S. tax

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[673] Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[674] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05, May 2005, 351; Senate Finance Committee Report to S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. 108-192, November 7, 2003, 161.

[675] Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861, June 23, 1984, at 1063-4. In *Trans City Life Insurance Company v. Comm'r*, 106 T.C. 274 (1996), *nonacq*., 1997-2 C.B. 1, the Tax Court held that two reinsurance agreements did not have significant tax avoidance effects, based on the application of these factors.

[676] Sec. 882.

withheld at a 30-percent rate on certain gross income (such as interest, dividends, rents, royalties, and premiums) derived from U.S. sources.[677]

A foreign company carrying on an insurance business in the United States that would be treated as a life insurer or a property and casualty insurer for Federal tax purposes if it were a domestic corporation is subject to U.S. tax under subchapter L on its income effectively connected with its conduct of any trade or business within the United States.[678] Special rules apply to calculate the minimum effectively connected net investment income for this purpose.[679] Other U.S.-source income of such a foreign company carrying on an insurance business in the United States is subject to the 30-percent gross-basis withholding tax applicable generally to U.S.-source income of any foreign corporation.

Treasury regulations provide, however, that insurance premiums subject to the insurance or reinsurance excise tax (described below) are not subject to the 30-percent gross-basis withholding requirement applicable for income tax purposes.[680]

Securities trading safe harbor

Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[681] Under these rules (colloquially referred to as trading safe harbors), trading in stock or securities or commodities by a foreign person through an independent agent such as a resident broker generally is not treated as the conduct of a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which the trading is effected. Trading in stock or securities or commodities for the foreign person's own account, whether by the foreign person or the foreign person's employees or through a resident broker or other agent (even if that agent has discretionary authority to make decisions in effecting the trading) also generally is not treated as the conduct of a U.S. business provided that the foreign person is not a dealer in stock or securities or commodities.

Exemption from 30-percent withholding for certain investment income

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent

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[677] Sec. 881.

[678] Sec. 842.

[679] Sec. 842(b). In *North West Life Assurance Co. of Canada v. Comm'r*, 107 T. C. 363 (1996), the Tax Court held that the business profits article of the United States-Canada income tax treaty permits a Canadian insurer doing business in the United States through a U.S. permanent establishment to attribute income to the permanent establishment based on its "real facts," not under the minimum investment income calculation of section 842(b).

[680] Treas. Reg. sec. 1.1441-2(a)(7); *see also* Treas. Reg. sec. 1.881-2(b).

[681] Sec. 864(b)(2).

withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax.[682] Original issue discount on obligations maturing in six months or less is also exempt from tax.[683] An additional exception is provided for certain interest paid on portfolio obligations.[684] Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder.[685] This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person.[686] Moreover, this exception is not available for certain contingent interest payments.[687]

Subpart F

Under the subpart F rules,[688] 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income (including foreign personal holding company income). The subpart F rules generally do not apply in the case of a foreign corporation that is controlled by foreign persons.

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[689] In general, the availability of the exception for income derived in the active conduct of a banking, financing, or similar business requires that the CFC directly receive at least 70 percent of its gross income from the active and regular conduct of a lending or finance business from transactions with customers who are unrelated persons. Similarly, the exception for income derived in the active conduct of an insurance business generally applies only to income received from unrelated persons.

[682] Secs. 871(i)(2)(A), 881(d).

[683] Sec. 871(g)(1)(B)(i).

[684] Secs. 871(h), 881(c).

[685] Sec. 871(h).

[686] Sec. 881(c)(3).

[687] Sec. 871(h)(4).

[688] Secs. 951-965.

[689] Secs. 953(e) and 954(h) and (i), which expired December 31, 2009.

Branch level taxes

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursuant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation.[690] The branch level taxes are comparable to these second-level taxes. In addition, where a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

Insurance and reinsurance excise tax

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[691] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Exemption from the excise tax

The United States has entered into comprehensive income tax treaties with more than 50 countries, including a number of countries with well-developed insurance industries such as Barbados, Germany, Switzerland, and the United Kingdom. The United States has also entered into a tax treaty with Bermuda, another country with a significant insurance industry, which applies only with respect to the taxation of insurance enterprises.[692]

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[690] Sec. 884.

[691] Secs. 4371-4374.

[692] The U.S.-Bermuda treaty generally exempts from U.S. taxation the business profits of a Bermuda insurance enterprise from carrying on the business of insurance (including insubstantial amounts of income incidental to such business), unless the insurance enterprise carries on business in the United States through a U.S. permanent establishment. For the purposes of the treaty, an insurance enterprise is defined as an enterprise whose predominant business activity is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business. The treaty also includes a mutual assistance provision.

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[693] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[694]

The U.S. tax treaties with Barbados and Bermuda also provide an exemption from the excise tax, although the Senate's ratification of the U.S.-Bermuda treaty was subject to a reservation with respect to the treaty's application to the excise tax. Moreover, section 6139 of the Technical and Miscellaneous Revenue Act of 1988 provides that neither the U.S.-Barbados nor the U.S.-Bermuda treaty will prevent imposition of the excise tax on premiums, regardless of when paid or accrued, allocable to insurance coverage for periods after December 31, 1989.[695] Accordingly, no exemption from the excise tax is available under those two treaties with respect to premiums allocable to insurance coverage beginning on or after January 1, 1990.

Earnings stripping rules

A foreign parent corporation with a U.S. subsidiary may seek to reduce the group's U.S. tax liability by having the U.S. subsidiary pay deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although the United States generally subjects foreign corporations to a 30-percent withholding tax on the receipt of such payments, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, foreign-owned domestic corporations may seek to use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.[696]

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[693] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

[694] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the Revenue Ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the Revenue Ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

[695] Pub. L. No. 100-647.

[696] For example, it appears that the U.S.-Barbados income tax treaty was used to facilitate earnings stripping arrangements in the context of corporate inversions. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. For a discussion of this issue, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty between the United States and Barbados* (JCX-55-04), September 16, 2004, at 12-20, 22.

Present law limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. A deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor" ratio); and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).[697] Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

The earnings stripping rules generally apply to interest, but do not apply to other deductible payments such as insurance or reinsurance premiums.

Description of Proposal

General rule

The proposal disallows any deduction to covered insurance companies for a certain fraction of reinsurance premiums with respect to U.S. risks paid to foreign affiliated insurance companies that are not subject to U.S. income taxation.

Covered insurance company

A covered insurance company for this purpose is any company subject to tax imposed by section 831 of the Code. Thus, for example, a property and casualty insurance company subject to tax in the United States is considered a covered insurance company under the proposal. The fact that a company subject to tax under section 831 has no tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to tax under section 831. All domestic members of a controlled group of corporations (as defined in section 1563, but using a 50-percent ownership threshold) of which a covered insurance company is a member are treated as one corporation.

The excise tax under section 4371 is disregarded for purposes of determining whether an affiliated insurance company is subject to U.S. income taxation.[698] Thus, for example, a foreign insurer or reinsurer that issues policies, premiums on which are subject to the excise tax under section 4371, and that is not subject to tax under section 831, is not considered an affiliated insurance company subject to U.S. income taxation for purposes of this proposal.

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[697] Sec. 163(j).

[698] Although this is not specified in the proposal, it is understood that this is the intent.

Deduction disallowed for certain reinsurance premiums

Under the proposal, the deduction for certain reinsurance premiums is disallowed. The amount disallowed for each line of business is the amount of reinsurance premiums paid (net of ceding commissions) in excess of 50 percent of premiums received by the taxpayer and its U.S. affiliates for direct insurance of U.S. risks.

Election to treat specified reinsurance income as effectively connected

The proposal provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. This election is intended to provide that these foreign affiliates are not treated less favorably than U.S. reinsurers, in the event that the proposal could be viewed as discriminatory under the nondiscrimination article of any U.S. tax treaty.

The election provides that an affiliated corporation may elect for any taxable year to treat certain premiums and certain net investment income as effectively connected with the conduct of a trade or business in the United States, and to be treated as carrying on an insurance business within the United States. Thus, an electing company is subject to the rules of present-law section 842 governing effectively connected income of foreign insurance companies carrying on an insurance business in the United States. As under present law, for purposes of this election, deductions are allowed only if and to the extent that they are connected with the income that is treated under this election as effectively connected with the conduct of a trade or business within the United States.

For purposes of the election, specified reinsurance income means, with respect to any taxable year, (1) all reinsurance premiums for which (but for this election) a deduction would be disallowed and that are received by a corporation during the taxable year directly or indirectly from covered insurance companies with respect to which the corporation is affiliated, and (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums with respect to which an election applies (whether for the current or a prior taxable year). The election may be revoked only with the consent of the Secretary.

Effective date

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

Analysis

Earnings stripping

The proposal reflects a concern with earnings stripping through the use of reinsurance transactions between related parties. Earnings stripping reduces the U.S. tax base through transactions involving deductible payments to foreign entities that are not subject to U.S. tax, generally to those that are related to the U.S. payor. Reinsuring risks with insurance affiliates generally can have the effect of reducing U.S. tax on earnings on reserves set aside to cover losses incurred with respect to those risks.

Because U.S. tax accounting rules applicable to insurance companies provide a deduction for additions to insurance reserves, investment earnings on insurance company reserves can be viewed as tax-favored.[699] The proposal addresses the point that the use of affiliated reinsurers is a means by which U.S. insurance risks migrate to offshore reinsurance markets so as to avoid U.S. tax on reserve earnings. The proposal provides for disallowance of the deduction for premiums for reinsurance with foreign affiliates that exceed a certain percentage of directly insured business.

Primary insurers have a variety of reasons for reinsuring some of their business. A principal reason is to shift risk, because an insurer's pool of risks is too concentrated in some manner. Additional nontax reasons for engaging in reinsurance transactions − whether assuming or ceding risks through reinsurance transactions − involve reduction in business volatility by managing exposure to extremely large losses,[700] compliance with State regulatory requirements for capital and surplus, financing for growth of existing and new lines of business, [701] and diversification by acquisition or divestiture of blocks of business or entire lines of business.[702]

Further, there are nontax reasons for reinsurance transactions with affiliates, including foreign affiliates. These nontax reasons include moving or centralizing capital within a corporate group to maximize efficient capital management, as well as reduction in the cost of reinsuring risks because the affiliates know more about each other and about the risks than do unrelated parties. There may be economies of scale in managing risk through reinsurance that may make it attractive to use reinsurance to consolidate the risks of an affiliated group in one entity, before subsequently shifting the risk to third parties or managing risk within the group. For example, risks that may partially or fully offset each other may serve to minimize volatility when the

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[699] Discounting rules applicable to tax reserves of property and casualty insurance companies partially take account of the time value of money (sec. 846).

[700] A primary insurer can use reinsurance to reduce exposure to extremely large losses from one source such as a catastrophic event (for example, a hurricane) or a particular environmental hazard (for example, asbestos). By reinsuring amounts above a certain level, the primary insurer can smooth loss payments over the year or between years. This can reduce volatility in the company's earnings.

[701] State insurance rules generally require that an insurance company maintain surplus, and the States limit the amount of new business the company can write based on a ratio of net premiums to surplus. Reinsuring some of the company's risks can lower the ratio of net premiums to surplus and allow the company to write more insurance. Thus, reinsurance can serve in effect as a form of financing for growth in the primary insurance company's business. The amount of net premiums for this purpose is determined net of premiums ceded to a reinsurer. Under State regulation, a ceding company treats amounts due from reinsurers as assets or reductions of liability, an accounting practice known as credit for reinsurance. See Joseph Sieverling and Scott Williamson, "The U.S. Reinsurance Market," in *Reinsurance: Fundamentals and New Challenges* (ed. Ruth Gastel), Insurance Information Institute (2004) at 126.

[702] By reinsuring a block of business, for example, a reinsurer can enter a new line of business more easily than by directly writing policies in that line of business. Similarly, a primary insurer can divest itself of a line of business by reinsuring its entire book of business in that line. See Donald A. McIsaac and David F. Babbel, "The World Bank Primer on Reinsurance," *Policy Research Working Paper 1512*, The World Bank (1995).

offsetting risk pools are centralized in one entity rather than being dispersed in separate affiliated entities. Affiliated groups may also experience transaction cost savings in financing risks.[703]

Tax benefits may also provide a reason for reinsurance transactions, including reinsurance transactions with affiliates. In general, premiums ceded for reinsurance are deductible in determining a company's Federal income tax.[704] Present law does not disallow this deduction if the affiliate to which the risks are ceded does not pay U.S. income tax on associated earnings. Thus, it is possible that a reinsurance transaction can be viewed as an earnings stripping transaction in some circumstances. Arguably, the earnings stripping concern arises if the reinsurer is an affiliate of the ceding company, and the parent of the affiliated group is not a U.S. corporation. In the reinsurance transaction, risks may be ceded to the foreign reinsurer, and along with the risks, earnings on the reserves relating to the ceded risks are shifted to the foreign reinsurer. In this circumstance, U.S. tax is not paid on the earnings on the reserves that are shifted overseas, even though these earnings remain within the affiliated group. This type of transaction has been criticized as tax-motivated.[705]

The approach taken in the proposal acknowledges that reinsurance has essential risk management and other functions. At the same time, the approach is structured to discourage reinsurance transactions that are likely to be motivated by avoidance of U.S. taxation because they exceed a fairly high threshold.

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[703] For example, when risks are centralized within an affiliated group, transaction costs of financing those risks may be reduced by issuing larger and fewer tranches of cat bonds. Catastrophe ("cat") bonds are an alternative risk transfer mechanism involving capital markets financing. See Karen Euwens, "Convergence Quarterly: Cat Bonds to Get Q4 Boost," Reactionsnet.com, 27 November 2009; Peter A. Gentile, Spencer M. Gluck, Peter Senak, and Jeffrey M. Stewart, Modern ART Practice, Gerling Global Financial Products 2000; Thomas Holzheu, "Alternative Risk Transfer (ART) Products," in Reinsurance: Fundamentals and New Challenges (ed. Ruth Gastel), Insurance Information Institute (2004), 113-124; "The Picture of ART," Sigma, Swiss Reinsurance Company Economic Research and Consulting (2003).

[704] Sec. 832(b)(4).

[705] See Jon Almeras and Ryan J. Donmoyer, "Insurers Approach Congress to Fix 'Bermuda Loophole,'" 86 *Tax Notes* 1660, Mar. 20, 2000; Lee A. Sheppard, "News Analysis – Would Imputed Income Prevent Escape to Bermuda?," 86 *Tax Notes* 1663, Mar. 20, 2000. And see Hearing of the Senate Committee on Finance, "Offshore Tax Issues: Reinsurance and Hedge Funds," September 26, 2007, Testimony of William R. Berkley, Chairman and CEO, W.R. Berkley Corporation: "Current law allows a U.S. member of a foreign–domiciled group to avoid paying U.S. tax on much of its domestic underwriting and investment income, merely by reinsuring its business with a related-party reinsurer domiciled in a country such as Bermuda or the Cayman Islands. By contrast, a U.S.-based insurance group must pay U.S. tax on all of its underwriting and investment income derived from writing similar domestic business." http://finance.senate.gov/sitepages/hearing092607.htm. See also Susanne Sclafane, "U.S. CEO on a Mission to Tax Bermuda Competitors," *National Underwriter Online News Service*, Nov. 20, 2006; Susanne Sclafane, "Bermuda CEO Fights Back on Tax Issue," *National Underwriter Online News Service*, Nov. 21, 2006. In 2002, in oral testimony before the Ways and Means Committee and in written response to a question, Pamela Olson, Acting Assistant Treasury Secretary for Tax Policy, stated, "The Treasury Department is concerned about the use of related party reinsurance to avoid U.S. tax on U.S. -source income. In particular, the use of related party insurance may permit the shifting of income from U.S. members of a corporate group to a foreign affiliate. Existing mechanisms for dealing with insurance transaction [sic] are not sufficient to address this situation." Hearing of the House Committee on Ways and Means on Corporate Inversions, June 6, 2002, Serial 107-73, pages 9-10 and 26, http://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/107cong/6-6-02/107-73final.htm.

Technical aspects of the operation of the proposal

50-percent threshold for deduction denial rule

The proposal imposes a 50-percent threshold for each line of business. If the portion of direct business reinsured with a foreign affiliate exceeds 50 percent, no deduction is allowed for reinsurance premiums in excess of this threshold under the proposal. The 50-percent threshold is unrelated to industry norms or recent industry practices relating to the portion of a line of business that is reinsured, whether with foreign affiliates or with third-party reinsurers, and exceeds the portion of business reinsured in many lines of business. A rationale for this approach may be to ensure that the proposal cannot possibly limit the deduction for reinsurance that is motivated by any reason other than avoidance of U.S. taxation, so that the proposal has little or no likelihood of overbreadth.

The proposal's 50-percent thresholds for each line of business could be criticized as either too generous for most lines of business, or as arbitrary at best. Arguably, the failure of the proposal to relate the disallowance to industry norms for reinsurance prevents the proposal from accurately distinguishing between reinsurance that is likely to be motivated by U.S. tax avoidance, and reinsurance that is typical and could be motivated by business, regulatory, or other nontax considerations. That is, without knowing what industry patterns of reinsurance in each line of business have been, it may be impossible to ascertain a base level of reinsurance that is fairly likely to reflect a need for risk-shifting, the most fundamental purpose for reinsurance. Thus, the 50-percent rule makes the proposal inefficient or perhaps ineffective at identifying earnings stripping reinsurance transactions. Further, based on industry data, the 50-percent threshold may be higher than the percentage of reinsurance in most lines of business, so the proposal has no effect at all in those lines of business. Nevertheless, in a few lines of business where industry norms for reinsurance have exceeded 50 percent, the proposal arbitrarily limits the deduction for reinsurance premiums.

The treatment of ceding commissions in determining the portion of reinsurance premiums for which no deduction is allowed can also be criticized as unrelated to the underlying business transaction. It is understood that the proposal permits the reduction of reinsurance premiums by the amount of all ceding commissions paid to foreign reinsurers. However, this measure of ceding commissions may be broader than the amount of ceding commissions that are included in the taxpayer's income under U.S. tax rules and that relate to foreign reinsurance premiums for which a deduction is disallowed under the proposal. Thus, an arbitrary portion (based on the level of ceding commissions in unrelated transactions) of reinsurance premiums is disallowed. In effect, the company is credited for ceding commissions on the portion of the premium for which it is not denied a deduction.

Treatment of assumed risks

It is understood that the proposal does not address the reinsurance of assumed U.S. risks, but rather, addresses only the reinsurance of directly insured U.S. risks. A rationale for this limited approach may be a concern about overbreadth, in that if the proposal applied to reinsurance of both directly insured and assumed U.S. risks, it could limit deductions for reinsurance that is not motivated by tax avoidance. A related rationale might be that it could be difficult to separate U.S. risks from other risks if assumed business included U.S. risks and other risks commingled in a block before being assumed; if this were the case, applying the proposal (which covers only U.S. risks) to assumed risks could be difficult for the government and taxpayers to administer and could involve additional recordkeeping.

An argument can be made, however, that applying a deduction disallowance rule only to direct business, and not to assumed risks, ignores the manner in which insurers do business and makes the proposal ineffective. Such an approach would create an incentive for fronting transactions in which U.S. direct insurers reinsure each other's U.S. risks before reinsuring the business with affiliates of the reinsured company. This simple avoidance technique could reduce the effectiveness of the proposal and arguably render it no more than a trap for the unwary. Further, it is unlikely that U.S. and other risks are commingled without records under current industry practice, so that administrability concerns are arguably misplaced.

Discussion of stacking rule

In determining whether a company has breached the 50-percent threshold, premiums to unaffiliated, or third-party, reinsurers is effectively stacked first, though a deduction for premiums paid to third-party reinsurers is never disallowed. This has the effect of making for a stricter rule, as the maximum amount of deduction would be disallowed for a given portfolio of reinsurance. Each dollar of third-party reinsurance increases the likelihood that an additional dollar of affiliate reinsurance is over the threshold. This has the potential to create perverse incentives for companies subject to the disallowance rule. This stacking rule could have the effect on the margin of encouraging more affiliate reinsurance for some companies. For example, a company that reinsures more than 50 percent of its direct business, but less than 50 percent with third-party reinsurers, may have an incentive to substitute affiliate reinsurance below the threshold for third-party reinsurance, as there is a potential to gain some of the benefits of affiliate reinsurance with no additional deduction disallowance. A company that reinsures more than 50 percent of its direct business with third-party reinsurers would not face the same incentive, as every dollar of third-party reinsurance above the threshold switched to an affiliated reinsurer would result in additional deduction disallowance.

Other issues

Nondiscrimination

The proposal provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. Nondiscrimination articles of U.S. tax treaties generally prohibit nationals of one treaty country from being subjected to more burdensome taxation (or any connected requirement) in the other treaty country than are nationals of that other treaty country in the same circumstances. It is believed that the proposal does not violate any nondiscrimination article of any applicable U.S. tax treaty.

Some may argue that the proposal violates these treaty requirements by denying deductions to U.S. affiliates of foreign companies when they reinsure with their foreign affiliates, but not applying a comparable deduction disallowance rule to U.S. companies reinsuring with their U.S. affiliates. Others may respond that the proposal does not violate any nondiscrimination article of any applicable U.S. tax treaty because the proposal provides an election for affiliated foreign reinsurers to be subject to U.S. tax on premiums and net investment income that is associated with affiliated reinsurance transactions. By making this election, any foreign reinsurance company can insure that it is treated at least as well as any U.S. insurance company.

In addition, U.S. tax treaties generally provide that the nondiscrimination article does not apply in certain cases involving transactions between related persons. One of these circumstances arises in cases in which paragraph 1 of Article 9 (Associated Enterprises) of a U.S. tax treaty applies. That paragraph applies in cases in which an enterprise of a treaty country is related to an enterprise of the other treaty country, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship.[706] The proposal sets forth a standard for determining reinsurance premiums in an arm's-length fashion. Thus, any reinsurance premiums that are disallowed under the proposal do not, by definition, satisfy the arm's-length standard and may properly be disallowed under U.S. tax treaties.[707]

Transfer pricing issues

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Within a controlled group, there are no market pressures that impose market pricing on transactions between related parties. The lack of an identifiable market price provides opportunities for companies to shift income among group members through controlled transactions at off-market prices.

To preserve the U.S. tax base, section 845 authorizes the Secretary of the Treasury to (1) allocate between or among two or more related persons (within the meaning of section 482) items of income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items); (2) recharacterizes any such items; or (3) make any other adjustment to reflect the proper amount, source, or character of the taxable income (or any item described in (1) relating to such taxable income) of each person. Section 842 generally does not prescribe any specific reallocation rules. Rather, it establishes the general standards of

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[706] United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 24, par. 4; Art. 9, par. 1.

[707] In a related vein, under principles relating to trade rather than purely to tax policy, it is argued that the proposal may violate Article XVII of the World Trade Organization General Agreement on Trade in Services (GATS), relating to national treatment. See Gary Clyde Hufbauer, "Protection by Stealth: Using the Tax Law to Discriminate against Foreign Insurance Companies," *Peterson Institute for International Economics* Policy Brief No. PB810-9, April, 2010 On the other hand, it may be argued that the proposal does not violate the GATS national treatment Article because, for example, the proposal is (1) a direct tax measure, and (2) based on objective criteria regarding the deductibility of payments that erode the U.S. tax base. Trade issues are beyond the purview of this analysis.

preventing tax evasion and clearly reflecting income. Treasury regulations under section 482 adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

The premium and ceding commission on reinsurance may be analogous to a transfer price for the underlying insurance risk. Following this analogy, a concern about excess affiliate reinsurance may be viewed as a concern about the transfer price. Opponents of the proposal may argue that Treasury authority under section 845, along with the presence of comparable third-party reinsurance transactions, is sufficient to combat any abuse in this area.

However, one of the purposes of affiliate reinsurance is to mitigate the effect of asymmetric information on increasing the price charged for reinsurance risk. That is, a third party may need to charge a higher premium to compensate itself for the uncertainty regarding the true nature of the risk being transferred.[708] This asymmetry suggests that third-party reinsurance may be an imperfect standard by which to judge the appropriateness of the transfer price for the insurance risk. To the extent that the third-party reinsurance premium is too high (or the ceding commission is too low) as a standard of comparison, it would lead to an understatement of income for the ceding company and an overstatement of income for the assuming company in the case of affiliated reinsurance.

A transfer pricing concern is also raised in statements in the legislative history of the 2004 amendment to section 845(a) with respect growth of offshore affiliate reinsurance.[709] If this analysis is accurate, the IRS may be able to apply section 845 in a particular case to reallocate income and deductions between such related parties on the basis of the argument that an unrelated party would not have reinsured such a large proportion of its U.S. risks. However, the IRS might be unsuccessful in challenging the questioned transactions. Further, it is difficult to obtain consistent results on a case by case basis applying transfer pricing concepts.

7. Limit earnings stripping by expatriated entities

Present Law

A U.S. corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[710] Generating excessively large

[708] Michael Cragg, J. David Cummins, and Bin Zhou, *The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis*, The Brattle Group, July 8, 2010, 11.

[709] Senate Finance Committee Report to S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. 108-192, November 7, 2003, 161, relating to section 845 of the Code.

[710] It is also possible for U.S.-controlled corporations to reduce their U.S. taxable income by making excessive deductible payments to foreign corporations that they control. In general, however, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

U.S. tax deductions in this manner is known as "earnings stripping." Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax may be reduced or eliminated under an applicable income tax treaty.

Although the term "earnings stripping" may be broadly applied to the generation of excessive deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above, more commonly it refers only to the generation of excessive interest deductions.[711] In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

Earnings stripping limitations

Present law limits the ability of foreign corporations to reduce the U.S. tax on the income derived from their U.S. subsidiaries' operations through earnings stripping transactions. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed to the extent that the payor's "net interest expense" (i.e., the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, depreciation, amortization, and depletion).[712] Disqualified interest includes interest paid or accrued to (1) related parties when no Federal income tax is imposed with respect to such interest;[713] or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

[711] Herein, except when noted otherwise, "earnings stripping" refers to the generation of excessive interest deductions.

[712] Sec. 163(j).

[713] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

Corporate inversion transactions

The United States employs a "worldwide" tax system, under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Foreign corporations are taxed by the United States only on income that has sufficient nexus to the United States. As a consequence, the U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. Tax rates vary by country, and not all countries choose a worldwide system of income taxation. Thus, depending upon its particular circumstances, a multinational group may be able to increase the after-tax returns to its investments by locating its parent corporation outside the United States.

For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.[714] All other corporations are generally treated as foreign.[715] Thus, the place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's shareholders.

Until recently, some U.S. multinational groups sought to take advantage of the differential treatment of U.S. and foreign domiciled top-tier companies through transactions commonly referred to as "inversions." A U.S. parent corporation could reincorporate in a foreign jurisdiction, potentially without any exit tax to compensate the U.S. for the loss of future tax revenue from the departing company. Under prior law, these inversion transactions could produce a variety of tax benefits, including the removal of a group's foreign operations from U.S. tax jurisdiction and, as discussed further below, the potential for reduction of U.S. tax on U.S.-source income through subsequent "earnings stripping" transactions (e.g., large payments of deductible interest or royalties from a U.S. subsidiary to the new foreign parent). It was not always clear, however, whether these inversions had a significant nontax purpose or effect, or whether the corporate group had a significant business presence in the new country of incorporation.

AJCA included provisions designed to curtail inversion transactions.[716] Most significantly, AJCA added section 7874 to the Code. That section defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. In an inversion transaction, a U.S. parent company is replaced with a foreign parent. The first type of inversion is a transaction in which (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a

[714] Sec. 7701(a)(4).

[715] Sec. 7701(a)(5).

[716] Pub. L. No. 108-357, sec. 801(a) (2004).

transaction completed after March 4, 2003;[717] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership, does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. Section 7874 denies the intended tax benefits of this type of inversion ("80-percent inversion") by deeming the top-tier foreign corporation to be a domestic corporation for all tax purposes, notwithstanding any other provision of the Code or a tax treaty.

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a 60-percent ownership threshold is met, then a second set of rules applies to the inversion ("60-percent inversion"). Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not generally offset by tax attributes such as net operating losses. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, generally without offset by any tax attributes (e.g., net operating losses). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.[718]

In both types of inversions, the domestic corporation (or partnership) that becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after March 4, 2003, or any U.S. person related to such a domestic corporation (or partnership), is referred to as an "expatriated entity."[719]

Description of Proposal

The proposal tightens the earnings stripping deduction limitations as applied to expatriated entities. Under the proposal, expatriated entities may not utilize the 1.5-to-1 debt-to-equity ratio safe harbor. In addition, the 50-percent of adjusted taxable income threshold for the

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

[718] Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership if, after the acquisition, at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met.

[719] Sec. 7874(a)(2).

limitation is reduced to 25 percent. The carryforward for disallowed interest is limited to 10 years and the carryforward of excess limitation is eliminated.

An expatriated entity is defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989.[720] This special rule does not apply, however, in the case of an 80-percent inversion in which the top-tier foreign corporation is treated as a domestic corporation for all tax purposes under section 7874.

Effective date.–The proposal is effective for interest paid or accrued in taxable years beginning after December 31, 2010.

Analysis

The number of corporate inversion transactions prior to the enactment of section 7874 led some, including the Treasury Department, to question the efficacy of the present-law earnings stripping rules.[721] In the case of some prominent, pre-AJCA corporate inversions, it appeared that the earnings stripping benefit achieved when a U.S. subsidiary paid deductible amounts to its new foreign parent or other foreign affiliates constituted the primary intended tax benefit of the inversion transaction, which should not have been the case if the earnings stripping rules had been functioning properly.[722] Thus, AJCA required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations as to how to improve the provisions of the Code applicable to earnings stripping.[723] The report, which was submitted to Congress on November 28, 2007,[724] is discussed in more detail below.[725]

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[720] This rule aligns the applicability of the inversion rules with the effective date of the original earnings stripping provision. The earnings stripping rules (section 163(j)) are generally applicable to instruments issued after July 10, 1989, with a grandfather rule for acquisitions made (or subject to a binding contract) on or before July 10, 1989.

[721] See, e.g., U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, p. 104 (2003) ("Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities."); Office of Tax Policy, U.S. Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Part VII.A (2002) ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited.").

[722] See, e.g., Office of Tax Policy, U.S. Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Part VII.A (2002); Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, pp. 3-4.

[723] Pub. L. No. 108-357, sec. 424 (2004). The report also includes AJCA-mandated studies on transfer pricing and U.S. income tax treaties. Pub. L. No. 108-357, sec. 806(a), (b) (2004).

[724] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007). Throughout the remainder of this part, "Treasury earnings stripping report" is used to refer to chapter II of this 2007 Treasury report, which specifically addresses earnings stripping, while

In summary, however, the 2007 Treasury report concludes that "[t]here is strong evidence that [inverted corporations] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping."[726] In reaching this conclusion, the report largely relies on an outside study of 12 inverted corporations[727] and a supplemental Treasury Department analysis of payments declared on Form 5472.[728] The Treasury earnings stripping report also concludes, however, that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,[729] and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.[730] Consistent with those conclusions, the proposal would change the earnings stripping rules for expatriated entities only. By eliminating the debt-equity safe harbor,[731] reducing the adjusted taxable income threshold from 50 percent to 25

"Treasury income tax treaty report" is used to refer to chapter IV of this 2007 Treasury report, which specifically addresses U.S. income tax treaties.

[725] Subsequent to the issuance of its Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, the Treasury Department's Office of Tax Analysis issued a paper that focuses solely on earnings stripping using the same 2004 dataset. The report reaches some of the same general conclusions as the Report with respect to its comparison of foreign-controlled domestic corporations to domestic-controlled corporations. Harry Grubert, "Debt and the Profitability of Foreign-Controlled Domestic Corporations in the United States," OTA Technical Working Paper 1 (2008).

[726] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 26.

[727] Jim A. Seida and William F. Wempe, "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion," *National Tax Journal* 57 (2004): 805-28 (hereafter, Seide and Wempe, Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion). Seide and Wempe found that the 12 inverted corporations had a significantly larger increase in foreign income and a significantly larger decrease in U.S. profit margin and effective tax rate than a control group of corporations. Seide and Wempe also more closely examined four inverted corporations for which detailed information on the levels of intercompany debt and interest and fee expense were readily available, and found that these levels increased significantly post-inversion. Moreover, for three of those four corporations, information could be determined regarding the geographic location of these attributes, and with respect to those three, most of the long-term debt, interest, and fee expense was attributable to the U.S. operations. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), pp. 21-22.

[728] Form 5472 is an information return of (1) a U.S. corporation owned 25 percent or more by one foreign person, or (2) a foreign corporation engaged in a trade or business within the United States. Such reporting is required under sections 6038A and 6038C. Form 5472 includes information on cross-border payments, including fees, interest, and royalties, between the reporting corporation and foreign-related persons.

[729] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 25.

[730] *Ibid*., p. 26.

[731] The Treasury earnings stripping report notes that all of the four more closely examined inverted corporations in the study by Seide and Wempe appear to be within the 1.5 to 1 debt-to-equity safe harbor. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax*

percent for interest on related-party debt, limiting the carryforward of disallowed interest to 10 years, and eliminating the carryforward of excess limitation, the proposal significantly strengthens rules that appear ineffective in preventing certain recent earnings stripping arrangements in the context of corporate inversion transactions.[732]

Earnings stripping by foreign-controlled domestic corporations–the conclusions of the Treasury report

The Treasury earnings stripping report presents three separate analyses using tax data to test whether foreign-controlled domestic corporations are engaging in earnings stripping outside the context of inversion transactions. First, the report examines the relative profitability of foreign-controlled domestic corporations and domestic-controlled corporations by comparing the ratios of net income to total receipts, concluding that foreign-controlled domestic corporations are generally less profitable than their domestic-controlled counterparts.[733]

Second, the Treasury earnings stripping report compares the ratios of "operating income" to total receipts for foreign-controlled domestic corporations to the corresponding ratios for domestic-controlled corporations. Operating income is defined as net income plus interest expense, depreciation, and similar items, and minus interest income, dividends, and royalties received. The report finds that, after adjusting for these items, foreign-controlled domestic corporations are generally more profitable than their domestic-controlled counterparts.[734] The data in this part of the study show that domestic-controlled corporations have greater interest expense as a proportion of total receipts than do foreign-controlled domestic corporations.[735]

Treaties (2007), p. 23; see also Seide and Wempe, Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion, p. 821.

[732] The 2007 Treasury report acknowledges that section 806 of AJCA requires the Treasury Department to conduct a study of the effectiveness of the provisions of AJCA relating to corporate expatriation, including the formulation of recommendations on improving the effectiveness of those provisions. The Treasury Department intends to separately issue to the Congress the report on that study. Nonetheless, the 2007 Treasury report states that "section 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations." U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 3.

[733] *Ibid.*, p. 13. These analyses were separately performed for the nonfinancial and financial sectors. In addition, a separate analysis was done for the manufacturing industry, which is a component of the nonfinancial sector.

[734] *Ibid.*, pp. 15-16. These analyses were separately performed for the nonfinancial and manufacturing sectors. The Treasury earnings stripping report's measure of operating income is reduced by non-interest expenses, such as research and experimentation, stewardship, and State and local taxes, that the taxpayer must allocate or apportion to foreign-source income for foreign tax credit purposes. Because by definition the foreign-source income associated with these expenses is generally excluded from operating income, adding back such expenses may provide the basis for a more valid comparison between foreign-controlled domestic corporations and domestic-controlled corporations.

[735] See *ibid.*, p. 15, table 2.2. This data, particularly the ratio of interest paid to total receipts, may suggest that foreign-controlled domestic corporations are not engaged in earnings stripping. However, it should be noted

It is unclear whether these findings with respect to profitability tend to support or refute the proposition that foreign-controlled domestic corporations engage in earnings stripping. Some might argue that even if the findings with respect to operating income suggest that foreign-controlled domestic corporations in the nonfinancial and, more specifically, the manufacturing sectors are more profitable than comparable domestic-controlled corporations before interest income and expense (and other non-operating items) are taken into account, the data presented do not identify how much of the interest income is received from, and interest expense is paid to, foreign-related parties, and, therefore, it is difficult to conclude that foreign-controlled domestic corporations are engaging in earnings stripping rather than utilizing third-party debt.[736]

Third, the Treasury earnings stripping report analyzes the relationship between interest expense and cash flow.[737] The report determines that, on average, foreign-controlled domestic corporations in the nonfinancial sector and the manufacturing industry have interest expense relative to cash flow that is virtually the same as comparable domestic-controlled corporations. The report also determines that foreign-controlled domestic corporations in these sectors are less likely to be above the section 163(j) threshold of 50 percent of adjusted taxable income than are comparable domestic-controlled corporations.[738] In the financial sector, the report determines that foreign-controlled domestic corporations in some industries appear to have significantly higher interest expense relative to cash flow than their domestic-controlled counterparts. However, the Treasury earnings stripping report states that "the comparison is not completely unambiguous and it is difficult to draw firm conclusions from the data because of the possibility of alternative explanations and the problems with using domestic-controlled corporations as a comparison group."[739]

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that it would be possible for a domestic-controlled corporation and a foreign-controlled domestic corporation to have similar interest expense burdens but have dissimilar reasons underlying their equivalent burdens. For example, a domestic-controlled corporation is more likely than a foreign-controlled domestic corporation to incur significant interest expense in the United States that may be linked (or, in technical terms of the Code, allocable or apportionable) to foreign-source income (and such income may be currently includible in U.S. taxable income or deferred), reflecting that foreign-controlled domestic corporations are more likely to incur interest expense solely for the purpose of financing economic activity conducted in the United States, while domestic-controlled corporations often incur interest expense in connection with the financing of both domestic and foreign entities in the overall corporate group. The same data issue may exist with respect to the interest expense and cash flow analysis set forth in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 18.

[736] Unfortunately, the Treasury earnings stripping report does not analyze the data from Form 5472 regarding interest payments from foreign-controlled domestic corporations to their foreign owners (i.e., disqualified interest). That analysis might have shed some light on the extent of any earnings stripping.

[737] The numerator, interest paid, used by the Treasury Department in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 18, takes into account interest expense linked to deferred income (both foreign- and domestic-source income), while neither cash flow nor total receipts, the alternative denominators, reflects this deferral. This asymmetry may affect the comparison of results for foreign-controlled domestic corporations and domestic-controlled corporations.

[738] *Ibid.*, p. 19.

[739] *Ibid.*, p. 21.

Thus, the Treasury earnings stripping report concludes that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,[740] and that it is not possible to determine with precision whether section 163(j) is effective in preventing earnings stripping by foreign-controlled domestic corporations.[741] The Treasury Department recommends gathering additional information from taxpayers relating to earnings stripping to determine whether it would be appropriate to modify the proposal with respect to foreign-controlled domestic corporations. Accordingly, on November 28, 2007, the Treasury Department and the IRS issued a proposed tax form, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*, to gather additional information from corporate taxpayers relating to the determinations and computations under section 163(j).[742] In December 2008, Form 8926 was issued in final form.

Discussion of wider points raised by Treasury earnings stripping report

Effects of debt financing

Like any business, a foreign corporation has the option of financing its U.S. subsidiaries through equity or some combination of debt and equity. There are certain advantages to utilizing some degree of debt financing—for example, debt financing may allow a business to raise funds at a lower cost (for example, the return to investors may be lower because debt is a less risky investment than an equity investment in the same business) and without surrendering ownership. Depending on the differences between the U.S. tax rate and the rate of tax imposed on the recipient of the interest by the applicable foreign country, the use of substantial debt financing, even if not rising to the level of earnings stripping, may facilitate lowering the aggregate burden of U.S. tax on the U.S. operations, thereby lowering the foreign parent corporation's overall tax rate on its worldwide operations. Moreover, even if the full 30-percent U.S. withholding tax is imposed upon the interest payment, there remains a five-percent taxpayer-favorable difference, if the interest expense is deductible at the highest U.S. corporate rate of 35 percent. In addition, the interest recipient may be able to take a credit for the U.S. withholding tax, in whole or in part, against its tax in the applicable foreign country, or the interest may be tax-exempt in such country. Although a foreign tax credit might also be available for withheld taxes on a dividend and the underlying U.S. corporate tax, in general there is a greater possibility of double taxation in the case of dividends paid by foreign-controlled domestic corporations to their parents than in the case of interest. Moreover, debt principal may be repaid on a tax-free basis, while redemption of equity by a foreign parent is generally treated as a dividend distribution unless the corporation paying the dividend has no earnings and profits.[743]

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[740] *Ibid.*, p. 25.

[741] *Ibid.*, p. 26.

[742] See Announcement 2007-114, 2007-50 I.R.B. 1176.

[743] See secs. 301, 302(d). If certain narrow exceptions are met, the distribution may be treated as a distribution in exchange for the stock. See sec. 302(b).

Studies have determined that, with some exceptions, greater investment is linked to overall higher labor compensation.[744] The Treasury earnings stripping report suggests that income shifting may support increased investment into high-tax jurisdictions (such as the United States) by lowering the effective tax rate.[745] Whether the ability of U.S. businesses to pay interest to related foreign debt-holders should be further abated may be part of a larger policy discussion that balances revenue and other needs in an international context.[746] It is difficult to determine the optimal rate of U.S. tax on foreign-controlled domestic corporations (or conversely, the appropriate level of leverage) that would maximize the overall economic benefit to the United States. However, the best way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrower policies such as the facilitation of earnings stripping.

Earnings stripping and tax treaties

Earnings stripping generally provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or a special tax regime for financing structures, and if that country has entered into a tax treaty with the United States that provides a reduced U.S. withholding tax rate on interest.

Thus, the applicable foreign tax rate and the U.S. withholding tax rate on the interest payment are two factors that affect the ability of foreign-controlled domestic corporations to effectively engage in earnings stripping. These two factors are interrelated. While a low foreign tax rate relative to the U.S. rate is critical to effective earnings stripping, if the general foreign tax rate is zero, it is not likely that the United States would now enter into a tax treaty with that foreign country that lowers the U.S. withholding tax rate on interest. Therefore, such a foreign

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[744] Recent references to this linkage include David L. Brumbaugh, Congressional Research Service, *Tax Treaty Legislation in the 110th Congress: Explanation and Economic Analysis* (CRS Report RL34245) (2008), p. 8.

[745] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 24. Existing empirical research does not address this question. *Ibid*. The linkage between foreign investment and labor compensation requires that a number of things be held constant–for example, that any potential loss of revenue associated with income shifting not also "crowd out" investment in the United States by either domestic or foreign investors.

[746] Notwithstanding that the two issues have historically been analyzed separately, a recent paper suggests that the determination of allowable interest deductions in the inbound and outbound contexts be coordinated through a multilateral agreement under which each country would allocate interest deductions to assets on a uniform worldwide basis and allow a proportionate amount of interest expense to be deducted against income earned domestically, without regard to where the borrowing occurs. The effect of such a system would be to deny interest deductions only when borrowing in one country is disproportionately higher than in the rest of the world. Michael Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," IBFD, *Bulletin for International Taxation* 62 (November 2008): 486.

corporation may attempt to utilize a U.S. tax treaty with another foreign country to obtain a lower U.S. withholding tax rate. This practice is known as treaty shopping.[747]

As described in detail in the Treasury income tax treaty report issued with the Treasury earnings stripping report, the Treasury Department has taken significant steps since 2000 to combat treaty shopping by negotiating new and stricter limitation-on-benefit ("LOB") provisions with several U.S. treaty partners, as well as including a similar new LOB provision in the United States Model Income Tax Convention of November 15, 2006. These stricter LOB provisions include a series of complex objective tests to determine whether a resident of a treaty country is sufficiently connected economically to that country to warrant receiving treaty benefits.[748]

Limitation of the scope of the proposal to expatriated entities

As discussed elsewhere in this document, certain of the Administration's other proposals may reduce somewhat the incentive that may exist under present law for certain U.S. persons to make investments outside of the United States, instead of within the United States, because of the more favorable U.S. tax treatment available for such foreign investments.[749] The same proposals may make corporate structures with a domestic parent relatively less attractive than corporate structures with a foreign parent because those proposals are more likely to raise the U.S. tax liability for the domestic parent structure than for the foreign parent structure. This proposal may counteract some of the U.S. tax advantage perceived to exist for foreign parent structures vis-à-vis domestic parent structures by significantly reducing opportunities for certain foreign parent structures (specifically, those involving domestic parent structures that inverted) to reduce their U.S. tax liability by engaging in earnings stripping using deductible interest. However, the effectiveness of this counterbalancing may be limited due to the fact that the proposal applies only to certain expatriated entities and not to, for example, newly established foreign-controlled domestic corporations.

Section 7874 appears to have significantly reduced the opportunity for domestic-controlled corporations to engage in earnings stripping by engaging in new inversion transactions.[750] However, both incentive and opportunity remain for foreign-controlled domestic

[747] Treaty shopping is not limited to withholding on interest payments. A person may engage in treaty shopping to obtain other benefits under a U.S. tax treaty, for example, to lower withholding on royalty or dividend payments, or to exempt income from a U.S. trade or business that is not attributable to a permanent establishment in the United States.

[748] See U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), pp. 78-82.

[749] See, for example, the analysis of the Administration's proposals to defer deduction of interest expense related to deferred income (Part VI.F.1) and to determine the foreign tax credit on a pooling basis (Part VI.F.2).

[750] The 2007 Treasury report states, "[s]ection 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations." U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 3. Recently, however, the IRS and Treasury Department issued temporary and proposed regulations addressing the application of section 7874 in certain circumstances. T.D. 9453, 74 Fed. Reg. 27,920 (June 12, 2009) (temporary regulations); 74 Fed. Reg. 27,947 (June 12, 2009) (proposed regulations). The preamble to the temporary regulations states that the IRS and

corporations (including new enterprises that opt out of U.S. residence for their top-tier entities), corporations that engage in 60-percent inversions, and corporations that inverted on or before March 4, 2003, to engage in earnings stripping. The proposal would further restrict earnings stripping for corporations that engage in 60-percent inversions and the pre-March 3, 2003 inverters,[751] but not for the much larger group of foreign-controlled domestic corporations that have not inverted.

Although recent legislative and treaty developments have removed some significant opportunities for earnings stripping, and notwithstanding that the Treasury earnings stripping report does not conclusively determine that foreign-controlled domestic corporations that are not expatriated entities are engaging in earnings stripping, some argue that, as a matter of tax policy, the earnings stripping rules should treat foreign-controlled domestic corporations in the same manner as expatriated entities because both types of corporations have the same incentives and capabilities to erode the U.S. tax base, and may do so in the same manner. Proponents of this argument observe that it should not be surprising that the available information clearly demonstrates that expatriated entities are engaging in earnings stripping because expatriated entities comprise an easily-identifiable subclass of foreign-controlled domestic corporations and have demonstrated a propensity for aggressive tax planning. Proponents of stricter across-the-board earnings stripping rules also argue that there is sufficient evidence of earnings stripping to justify implementing such a regime, and that significant erosion of the U.S. tax base will continue until the earnings stripping rules are strengthened for all foreign-controlled domestic corporations.

Others agree with the conclusion of the Treasury earnings stripping report that there is insufficient evidence to justify legislative action outside the context of inversions at this time, and that it would be more prudent to await the receipt and analysis of taxpayer data on earnings stripping submitted through the new Form 8926. Proponents of this view may also believe that the implementation of the new form should increase compliance with section 163(j). In response, some argue that it will be at least several years before careful analyses can be performed on any data submitted through Form 8926, and that there is currently sufficient

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Treasury Department have become aware of certain transactions that are intended to avoid section 7874, but that they believe present the same policy concerns that prompted the enactment of section 7874. Thus, the temporary and proposed regulations clarify that such transactions are still within the scope of section 7874. In particular, the temporary and proposed regulations address transactions that utilize multiple foreign corporations to make acquisitions of substantially all of the properties held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership, transactions involving one foreign corporation acquiring substantially all of the properties of multiple domestic corporations or partnerships, and transactions involving an insolvent domestic corporation in which the creditors of the corporation claim not to be shareholders. In addition, in September 2009, the IRS issued a notice providing guidance on additional transactions involving a transfer of cash (or certain other assets) to a foreign corporation to limit the application of section 7874. Notice 2009-78, 2009 I.R.B. 40. The notice also indicated that Treasury and the IRS intend to issue further regulations under section 7874 addressing these and other transactions.

[751] Some might argue that it is unfair to impose an additional tax burden on corporations on the basis of transactions occurring in part prior to the time the transactions were addressed by the Code. However, the proposal would be effective only with respect to interest paid or accrued in taxable years beginning after December 31, 2010. Therefore, it is not retroactive in effect.

concern and anecdotal evidence regarding earnings stripping by foreign-controlled domestic corporations to justify strengthening the substantive earnings-stripping rules now, while continuing to analyze data as it becomes available.

Other types of earnings stripping

The proposal does not address earnings stripping transactions involving the payment of deductible amounts (by expatriated entities or foreign-controlled domestic corporations) other than interest (e.g., rents, royalties, and service fees), or the payment of deductible amounts by taxpayers other than corporations.[752] These transactions also may erode the U.S. tax base, and thus some argue that a more comprehensive response to earnings stripping is needed. The Treasury Department's examination of payments declared on Form 5472 by seven expatriated entities suggests that, although the majority of earnings stripping by expatriated entities is through interest, some earnings stripping occurs through royalties.[753] Indeed, as opportunities for earnings stripping through interest payments are reduced, taxpayers may find it increasingly attractive to strip earnings through other means. On the other hand, earnings stripping may be more readily achieved through the use of debt than through other means.[754]

Prior Action

The President's fiscal year 2009 and 2010 budget proposals contained a similar earnings stripping proposal, except that it provided that the 50-percent of adjusted taxable income threshold generally continued to apply to interest on guaranteed debt. The President's fiscal year 2005, 2006, 2007, and 2008 budget proposals contained a similar, but broader, proposal that would have applied regardless of whether an inversion had occurred. The President's fiscal year 2004 budget proposals contained a different earnings stripping proposal that would have modified the safe harbor provision, reduced the adjusted taxable income threshold, added a new disallowance provision based on a comparison of domestic to worldwide indebtedness, and limited carryovers.

Earlier this year, the House passed a provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign related party may not be reduced under a U.S. treaty unless such withholding tax would be reduced under a U.S. treaty if such payment were made directly to the foreign parent corporation.[755] The House passed the

[752] However, a separate proposal contained in the President's fiscal year 2011 budget would disallow the deduction for excess nontaxed reinsurance premiums paid to affiliates. See Part VI.F.6 of this document for a discussion of that proposal.

[753] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 22.

[754] The Treasury Department notes that capitalizing a foreign-controlled domestic corporation with a disproportionate amount of debt to engage in earnings stripping does not generally require any real movement of assets or a change in the business operations of the corporation. In contrast, the use of royalties or other deductible payments may require a real change in business operations. See *ibid.*, p. 7 & n.1.

[755] H.R. 4849, 111th Cong. sec. 301 (2010).

same provision in 2008 and 2009.[756] In 2007, the House passed a similar, but somewhat broader provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign related party may not be less than the amount which would be imposed if the payment were made directly to its foreign parent corporation.[757] In each of these cases, the provision would apply to all deductible payments to foreign related parties, and not solely to interest.

In 2006, the Senate passed a provision applicable to certain expatriated entities that would have eliminated the safe harbor and reduced the present-law threshold of 50 percent of adjusted taxable income to 25 percent for both net interest expense and excess limitation.[758]

In 2004, prior to AJCA's enactment, the Senate passed a provision that would have tightened the interest stripping rules for corporations that had engaged in certain inversions. For these corporations, the proposal would have eliminated the debt-to-equity safe harbor, reduced the threshold for excess interest expense to 25 percent of adjusted taxable income, and modified the excess limitation threshold so that 25 percent of adjusted taxable income over a corporation's net interest expense for a year could be carried forward three years.[759]

8. Repeal 80/20 company rules

A provision substantially similar to the President's fiscal year 2011 budget proposal was included in H.R. 1586, which was signed into law by the President on August 10, 2010.

9. Prevent the avoidance of dividend withholding taxes

A provision substantially similar to the President's fiscal year 2011 budget proposal was enacted as part of the Hiring Incentives to Restore Employment Act.[760]

10. Modify the tax rules for dual capacity taxpayers

Present Law

The United States taxes its citizens and residents (including U.S. corporations) on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S.

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[756] H.R. 3962, 111th Cong. sec. 561 (2009); H.R. 6275, 110th Cong. sec. 203 (2008). The provision was identical to one introduced by the Chairman of the Committee on Ways and Means in 2007. H.R. 3970, 110th Cong. sec. 3204 (2007).

[757] H.R. 2419, 110th Cong. sec. 12001 (2007).

[758] H.R. 4297, 109th Cong. sec. 441 (2006); see H.R. Rep. No. 109-455, at 245-50 (2006).

[759] S. 1637, 108th Cong. sec. 441(d)(2) (2004).

[760] Pub. L. No. 111-147.

persons may be subject to double taxation. To mitigate this possibility, the United States generally provides a credit against U.S. tax liability for foreign income taxes paid or accrued.[761]

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. Treasury regulations under section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax. In general, a foreign levy is considered a creditable tax if it is substantially equivalent to an income tax under U.S. tax principles. Under the present Treasury regulations, a foreign levy is considered a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country.[762]

Dual capacity taxpayers

A taxpayer that is subject to a foreign levy and also receives a specific economic benefit from the foreign country is considered a "dual capacity taxpayer."[763] A "specific economic benefit" is broadly defined as an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general.[764] An example of a specific economic benefit includes a concession to extract government-owned petroleum. Other examples of economic benefits that may be specific if not provided on substantially the same terms to the population in general, include property; a service; a fee or other payment; a right to use, acquire or extract resources, patents, or other property that a foreign country owns or controls (as defined within the regulations); or a reduction or discharge of a contractual obligation.

Treasury regulations addressing payments made by dual capacity taxpayers were developed in response to the concern that payments which purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in substance, royalties or some other business expense.[765] To the extent that a taxpayer meets the definition of a dual capacity taxpayer, the taxpayer may not claim a foreign tax credit for the portion of the foreign levy that is paid for the specific economic benefit.[766] Treasury regulations require that a dual capacity taxpayer, similar to other taxpayers, must establish that the foreign

[761] Sec. 901.

[762] Treas. Reg. sec. 1.901-2(a)(2)(i).

[763] Treas. Reg. sec. 1.901-2(a)(ii).

[764] Treas. Reg. sec. 1.901-2(a)(2)(ii)(B).

[765] Testimony of Treasury Secretary Schultz, Hearings on "Windfall" Excess Profits Tax before the House Committee on Ways and Means, 93rd Cong., 2d Sess. 151 (1974).

[766] Treas. Reg. sec. 1.901-2A(a)(1).

levy meets the requirements of section 901 or section 903.[767] However, the regulations require that a dual capacity taxpayer use either a facts and circumstances method or a safe harbor method in establishing the foreign levy is an income tax.[768]

Under the facts and circumstances method, a separate levy is creditable to the extent that the taxpayer establishes, based on all the relevant facts and circumstances, the amount of the levy that is not paid as compensation for the specific economic benefit.[769] For purposes of applying the facts and circumstances method, the foreign country need not have a generally imposed income tax.

A dual capacity taxpayer alternatively may choose to apply the safe harbor method on a country-by-country basis to determine whether a levy is a creditable tax.[770] Under the safe harbor method, if the foreign country has a generally imposed income tax, the taxpayer may credit the portion of the levy that application of the generally imposed income tax would yield provided that the levy otherwise constitutes an income tax or an in lieu of tax. The balance of the levy is treated as compensation for the specific economic benefit.[771] If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable U.S. federal tax rate, applied to net income, is treated as a creditable tax.[772] In general, a foreign tax is treated as generally imposed for this purpose even if it applies only to persons who are not residents or nationals of that country.[773]

After the promulgation of the regulations, many dual-capacity taxpayers elected the safe harbor method for determining what portion, if any, of the separate foreign levy they paid would be treated as a creditable income tax. However, in 1999, the Tax Court in Exxon Corp. v. Commissioner determined that the entire amount of the petroleum revenue tax paid by Exxon to the U.K. government did not constitute compensation for a specific economic benefit and would thus qualify as tax for purposes of the foreign tax credit.[774] The Court considered that Exxon

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767 Treas. Reg. sec. 1.901-2A(b)(1).

768 Treas. Reg. sec. 1.901-2A(c).

769 Treas. Reg. sec. 1.901-2A(c)(2).

770 A taxpayer may make an election to use the safe harbor method with respect to one or more foreign states. The election applies to the year of the election and to all subsequent taxable years unless revoked. The election is made by the common parent and applies to all members of the affiliated group. See Treas. Reg. sec. 1.902-2A(d).

771 Treas. Reg. sec. 1.901-2A(d) and (e). Detailed rules are provided for determining the amount that imposition of the generally applicable tax to the dual capacity taxpayer would yield, based on the taxpayer's gross receipts, costs and expenses, and other factors.

772 Treas. Reg. sec. 1.901-2A(e)(5).

773 See Treas. Reg. sec. 1.903-1(b)(3), Ex. 4.

774 *Exxon v. Commissioner*, 113 T.C. 338 (1999). See also *Philips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995).

entered into an arm's length licensing agreement with the U.K. government to gain access to the North Sea oil fields prior to the enactment of the petroleum revenue tax, and determined that Exxon's right to explore, develop and exploit petroleum resources was dependent on the licensing agreement and payment of license fees under that agreement and not in exchange for payment of the tax. Subsequent to the decision in *Exxon*, anecdotal evidence suggests that a significant number of dual-capacity taxpayers revoked their safe harbor elections and adopted the facts and circumstances method to argue for tax treatment for the entire amount of the qualifying levy.

Limitation on the use of foreign tax credits

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[775] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the immediately preceding taxable year or carry forward the excess taxes forward 10 years.[776]

In addition, this limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of foreign taxes attributable to income in a separate limitation category that may be claimed as credits may not exceed the proportion of the taxpayer's total U.S. tax liability which the taxpayer's foreign-source taxable income in that separate limitation category bears to the taxpayer's worldwide taxable income. The separate limitation rules are intended to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income.[777]

Special rule for foreign oil and gas income

A special limitation applies with respect to taxes on combined foreign oil and gas income applied prior to the foreign tax credit limitation discussed above.[778] This limitation was adopted

[775] Secs. 901 and 904.

[776] Sec. 904(c).

[777] Sec. 904(d). For taxable years beginning prior to January 1, 2007, section 904(d) generally provides eight separate limitation categories (or "baskets") and effectively many more in situations in which various special rules apply. The American Jobs Creation Act of 2004 reduced the number of baskets from nine to eight for taxable years beginning after December 31, 2002, and further reduced the number of baskets to two (i.e., "general" and "passive") for taxable years beginning after December 31, 2006. Pub. L. No. 108-357, sec. 404 (2004).

[778] Sec. 907. For taxable years beginning before January 1, 2009, the components of what is now defined as combined foreign oil and gas income included foreign oil and gas extraction income ("FOGEI") and foreign oil related income ("FORI"). Under the prior rules, FOGEI and FORI were subject to separate limitations under section

prior to the issuance of the regulations providing the rules discussed above for dual capacity taxpayers to address the concern that payments made by oil companies to many oil-producing nations were royalties disguised as tax payments.[779] Additionally, the limitation sought to prevent the crediting of high foreign taxes on foreign oil and gas income against the residual U.S. tax on other types of lower-taxed foreign source income.[780]

Under this special limitation, amounts claimed as taxes paid on combined foreign oil and gas income are creditable in a given taxable year (if they otherwise qualify as creditable taxes) only to the extent they do not exceed the applicable U.S. tax on that income. The applicable U.S. tax is determined for a corporation as the product of the amount of such combined foreign oil and gas income for the taxable year and the highest marginal tax rate for corporations.[781] Any excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year.[782] Amounts that are not limited under section 907 (relating to combined foreign oil and gas income discussed above) are included in the general basket or passive basket (as applicable) for purposes of applying the section 904 limitation.

Description of Proposal

In the case of a dual capacity taxpayer, the proposal allows a taxpayer to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual-capacity taxpayer. The proposal replaces the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax. The proposal also converts the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The proposal yields to U.S. treaty obligations to the extent that they allow a credit for taxes paid or accrued on certain oil or gas income.

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907. Pub. L. No 110-343, Sec. 402(a). Amounts claimed as taxes paid on FOGEI of a U.S. corporation qualified as creditable taxes (if they otherwise so qualified), if they did not exceed the product of FOGEI multiplied by the highest marginal U.S. tax rate on corporations. A separate limitation was deemed to apply to FORI which theoretically applied in certain cases where the foreign law imposing such amount of tax is structured, or in fact operated, so that the amount of tax imposed with respect to FORI generally was "materially greater," over a "reasonable period of time," than the amount generally imposed on income that was neither FORI nor FOGEI. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress*, (JCS-1-09), March 2009, at 358.

[779] Joint Committee on Taxation, *Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, (JCS-38-82), December 31, 1982, sec. IV.A.7.a, fn 63.

[780] H.R. Conf. Rept. No. 103-213, at 646 (1993).

[781] Sec. 907(a). For an individual, the limitation is the product of the amount of such combined foreign oil and gas income for the taxable year and a fraction, the numerator of which is the tax against which the credit under section 901(a) is taken and the denominator of which is the taxpayer's entire taxable income.

[782] Sec. 907(f).

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

Analysis

The proposal addresses the distinction between creditable taxes and non-creditable payments that are made in exchange for a specific economic benefit by denying a foreign tax credit for amounts paid by a dual-capacity taxpayer that exceed the foreign tax that would be paid if the taxpayer were not a dual-capacity taxpayer. Thus, the proposal would create a non-rebuttable presumption that a tax paid by a dual-capacity taxpayer to a foreign government is for a specific economic benefit to the extent the tax exceeds the tax that would be paid by a non-dual-capacity taxpayer.

As discussed above, the catalyst for the present regulations governing the creditability of payments made by dual-capacity taxpayers was a concern that payments purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in substance, royalties or some other business expense. The present regulations mitigate this concern, but under either the facts and circumstances or safe-harbor method, a foreign levy is treated as a creditable tax, despite there being a lower or no generally imposed income tax on persons other than dual-capacity taxpayers.[783] Thus, under the present regulatory regime, there is a general presumption that the foreign levy represents a tax, even where the levy is either imposed at a higher rate or imposed solely on dual-capacity taxpayers. The proposal effectively reverses that presumption by allowing a dual-capacity taxpayer to treat as income tax only the portion of the foreign levy that the dual-capacity taxpayer would pay had it not been a dual-capacity taxpayer.

Although primarily applicable to oil and gas producers (and other companies engaged in mineral extraction businesses), the "dual-capacity" taxpayer provisions are broadly applicable to any taxpayer that is treated under the regulations as receiving a specific economic benefit from a foreign government.[784] Thus, for example, a corporation engaged in a banking business that loans funds to a foreign government may meet the definition of a dual-capacity taxpayer and therefore be subject to the provisions in the Administration's proposal. As a result, if the foreign country imposes no income tax on persons other than dual-capacity taxpayers, the taxes paid by the bank would not be creditable.[785]

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[783] As discussed above, in a foreign jurisdiction that imposes a generally applicable income tax, the foreign tax credit cannot exceed the liability of the taxpayer had the taxpayer been subject to the general income tax. If the foreign jurisdiction has no generally imposed income tax, the foreign tax credit cannot exceed the applicable U.S. tax. See Treas. Reg. sec. 1.901-2A(d) and (e).

[784] The proposed Energy Security and Corporate Accountability Act of 2007 includes a provision that is based on prior versions of this proposal but only applies to dual-capacity taxpayers that are major integrated oil companies (as defined in sec.167(h)(5)(B)). See S. 1287, 110th Cong. sec. 3 (2007).

[785] Treas. Reg. sec. 1.901-2A(c)(2)(ii), Example 1. In this example, the taxes paid by the bank were creditable because the bank met its burden of proof under the facts and circumstances method.

Present law arguably fails to achieve the appropriate allocation between a payment for specific economic benefit and a creditable tax in those cases where the foreign country either imposes a levy on an item, but does not otherwise generally impose an income tax, or imposes a higher levy on dual-capacity taxpayer than the levy imposed on non-dual-capacity taxpayers. Thus, the proposal would ensure that the levy is not a payment for a specific economic benefit.[786]

Moreover, the proposal provides a clear, objective test to determine what portion of the foreign levy, if any, reflects payment for a specific economic benefit. Thus, unlike the facts and circumstances test which has been the subject of controversy between the IRS and taxpayers, the proposal provides for a more objective standard that would be easier to administer.

Nonetheless, the proposal could create situations in which double taxation may arise. Instead, if the dual-capacity taxpayer can establish that it is paying fair compensation to the foreign country for the economic benefit received from that country, amounts paid pursuant to the foreign levy on net income or a levy on excess profits should constitute a creditable tax, notwithstanding that the foreign country imposes lower or no income tax on non-dual-capacity taxpayers.[787]

Furthermore, a fundamental assumption behind the proposal, that countries generally seek to impose an equal tax burden on all taxpayers and therefore any additional tax burden imposed solely on dual-capacity taxpayers reflects payment for a specific economic benefit, is arguably incorrect. Taxing jurisdictions often impose different levels of tax burden on different industries according to various factors including the relative mobility of a particular industry.[788] A taxpayer in a relatively immobile industry, such as a company engaged in a natural resource extraction industry, is compelled to operate within the natural resource's jurisdiction notwithstanding a relatively high tax rate. In contrast, a taxpayer in a relatively mobile industry may have more flexibility in choosing the taxing jurisdiction in which it is established. To attract in-country investments of mobile industries, taxing authorities may offer incentives to such industries, including a lower tax rate. Thus, the additional tax burden on oil companies, as well as others operating in immobile industries, is arguably not a payment for a specific economic benefit, but simply reflects the jurisdiction's ability to impose a higher tax on an immobile industry.

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[786] For example, under a recently enacted tax reform, Qatar, one of the world's largest petroleum exporters, replaced its progressive corporate tax rate schedule of up to 35 percent to a flat rate of 10 percent. Taxable entities carrying on oil operations (as defined) are subject to tax under the provisions of the agreements they entered into with the state. The tax rate, however, may not be less than 35 percent. IBFD Tax News Services, Report from Mr. Salah Gueydi, Qatar, *New Income Tax Law - details*, January 13, 2010. Also, in addition to other taxes it levies on oil and gas extraction activities (e.g. the Petroleum Revenue Tax), the United Kingdom taxes oil and gas operations at a higher rate of 30 percent compared to a standard corporate tax rate of 28 percent and small companies rate of 21 percent. Business Operations in the United Kingdom, Tax Management Portfolio No. 997-5th, IX, J.

[787] See, e.g., Exxon Corp., et. al. v. Commissioner, 113 T.C. 338 (1999).

[788] For example, in the United States certain industries' tax burdens are reduced through the domestic manufacturing deduction under section 199.

Those opposing the proposal also point out that the major U.S. based oil companies would be disadvantaged relative to foreign competitors in bidding for new projects as a result of the increased costs.[789] This reduced competitiveness could, it is contended, impair energy security in the United States.

The proposal also includes a separate foreign tax credit limitation category that applies to combined foreign oil and gas income and eliminates the present-law special limitation for combined foreign oil and gas income under section 907. Some have argued that the original concerns that gave rise to the section 907 rules – royalties being disguised as foreign levies and the cross-crediting of taxes paid at high rates on foreign oil and gas related income against U.S. tax on other low-taxed income – have been sufficiently addressed by other provisions and that section 907 adds unnecessary complexity and should be repealed.[790] Arguably, the disguised royalties issue was addressed by the dual-capacity taxpayer rules. However, as discussed above, the present law dual-capacity taxpayer rules permit certain foreign levies to be treated as creditable even though the foreign country imposes lower or no levies on non-dual-capacity taxpayers. If the proposed modifications to the dual-capacity taxpayer rules were enacted, these changes may render section 907 unnecessary in preventing crediting of disguised royalties. However, the cross-crediting of high taxes paid on extraction income against other income is a section 904 concern that is not addressed by changes to the amount of the foreign levy that qualifies under section 901.

Furthermore, the recent change combining FOGEI and FORI into combined foreign oil and gas income allows for substantial cross-crediting of extraction taxes against U.S. tax on low-taxed downstream FORI income. By replacing section 907 with a separate section 904 limitation category for foreign oil and gas income, the proposal would restrict cross-crediting of oil and gas related taxes against other general category income as well as prevent the use of excess credits on other general category income from offsetting U.S. tax on low-taxed FORI for taxpayers that do not have extraction income. At the same time, the proposal would simplify credit calculations because present law requires that the special section 907 limitation be applied first, followed by application of the section 904 limitation.

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[789] In contrast to U.S. dual capacity taxpayers, many of these foreign competitors may be headquartered in jurisdictions with territorial tax regimes that do not tax active foreign earnings. See also Testimony of C. Ellen MacNeil on behalf of the American Petroleum Institute, Hearing on the revenue provisions in the President's Fiscal Year 1998 before the House Committee on Ways and Means, 10th Cong., 1st Sess. 1 (1997).

[790] U.S. National Foreign Trade Council, Inc., *The NFTC Foreign Income Project: International Tax Policy for the 21st Century*, *2002 Tax Notes Today 66-57* (December 15, 2001); Statement by Gregory S. Nickerson and Fred Murray of National Foreign Trade Council, Inc. relating to National Foreign Trade Council Comments on Joint Committee on Taxation Study of Overall State of Federal Tax System and Recommendations for Simplification before the Committee on Finance United States Senate, 107th Congress, May 14, 2001.

Prior Action

Proposals revising the treatment of dual-capacity taxpayers have been included in the President's fiscal year 1998, 1999, 2000, 2001 and 2010 budget proposals. The proposal in the fiscal year 1998 budget proposal included an additional modification with respect to the treatment of foreign oil and gas income under subpart F of the Code which is not included in this proposal.

G. Combat Under-Reporting of Income on Accounts and Entities in Offshore Jurisdictions

Provisions substantially similar to several of the President's fiscal year 2011 budget proposals on combating under-reporting of income on accounts and entities in offshore jurisdictions were enacted as part of the Hiring Incentives to Restore Employment ("HIRE") Act,[791] on March 18, 2010.

The proposals enacted as part of the HIRE Act are as follows:

- Require Increased Reporting on Certain Foreign Accounts
- Require Increased Reporting with Respect to Certain Recipients of FDAP Income or Gross Proceeds
- Repeal Certain Foreign Exceptions to Registered Bond Requirements
- Require Disclosure of Foreign Financial Assets to be Filed with Tax Return
- Impose Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets
- Extend Statute of Limitations for Significant Omission of Income Attributable to Foreign Financial Assets
- Permit the Secretary to Require Electronic Filing by Financial Institutions of Certain Withholding Tax Returns
- Establish Presumption of U.S. Beneficiary in Case of Transfers to Foreign Trusts by a U.S. Person
- Treat Certain Uncompensated Uses of Foreign Trust Property as a Distribution to U.S. Grantor or Beneficiary
- Improve Foreign Trust Reporting Penalty

1. Require reporting of certain transfers of assets to or from foreign financial accounts

Present Law

Various self-reporting requirements apply to U.S. persons who engage in cross-border activities. The obligations to report are established by both the Code and Title 31 of the United States: "Title 31 of the United States Code, the Bank Secrecy Act," as described below.

Reporting required by the Code

For all U.S. persons, the Code requires self-reporting on the formation and funding of foreign entities. The Foreign Account Tax Compliance Act ("FATCA"), enacted as subtitle A of

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791 Pub. L. No. 111-147.

Title V of the Hiring Incentives to Restore Employment (HIRE) Act,[792] added section 6038D, which requires that individuals disclose certain foreign financial assets and imposes penalties for failure to disclose such assets.

To the extent that a U.S. person engages in foreign activities indirectly through a foreign business entity, the Code imposes certain other self-reporting requirements. Upon the formation, acquisition or ongoing ownership of certain foreign corporations, U.S. persons that are officers, directors, or shareholders must file a Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations,"[793] identifying the foreign corporation, amount of stock held, principal business and functional currency of the corporation. Similar information with respect to interests in a controlled foreign partnership is required to be reported on Form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships." Form 8858, "Information Return of U.S. Persons With Respect To Foreign Disregarded Entities," must be filed with respect to a foreign disregarded entity.[794] As part of the initial formation of a foreign business entity, the foreign business entity is often capitalized with cash as well as other assets and liabilities. If the foreign entity receiving such contributions is a foreign corporation, the U.S. person capitalizing the entity will be required to file Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."[795]

New section 6038D reporting by individuals

An individual taxpayer with an interest in a "specified foreign financial asset" during the taxable year is required to attach a disclosure statement to his or her income tax return for any year in which the aggregate value of all such assets is greater than $50,000 or such other higher amount as the Secretary may prescribe. Although the nature of the information required is similar to the information required to be disclosed on the form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," it is not identical.[796] For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value of his interest in the trust together with the value of other specified foreign financial assets exceeds the aggregate value threshold. Compliance with section 6038D is not a substitute for compliance with the FBAR reporting requirements.

"Specified foreign financial assets" are interests in depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, (1)

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[792] Pub. L. No. 111-147.

[793] Secs. 6038 and 6046.

[794] The Form 8858 is used to satisfy reporting requirements of sections 6011, 6012, 6031, and 6038, and related regulations.

[795] Sec. 6038B. The filing of Form 926 may also be required upon future contributions to the foreign corporation.

[796] Generally referred to as FBAR, the form is an annual report required by the Bank Secrecy Act. Its requirements are discussed in the following section.

stocks or securities issued by foreign persons, (2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (3) any interest in a foreign entity. The information to be included on the statement includes identifying information for each asset and its maximum value during the taxable year. For an account, the name and address of the institution at which the account is maintained and the account number are required. For a stock or security, the name and address of the issuer, and any other information necessary to identify the stock or security and the class or issue of which it is a part must be provided. For all other instruments or contracts, or interests in foreign entities, the information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counterparties. An individual is not required under this provision to disclose interests held in a custodial account with a U.S. financial institution. An individual need not separately identify any stock, security instrument, contract, or interest in a foreign financial account disclosed under the provision. In addition, the provision permits the Secretary to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold specified foreign financial assets, directly or indirectly.

Enforcement of section 6038D

Individuals who fail to make the required disclosures without reasonable cause are subject to a penalty of $10,000 for the taxable year. Foreign law prohibitions against disclosure of the required information cannot be relied upon to establish reasonable cause. An additional penalty may apply if the Secretary notifies an individual by mail of the failure to disclose and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by $10,000 for each subsequent 30-day period (or a fraction thereof), up to a maximum penalty of $50,000 for one taxable period. The computation of the penalty is similar to that applicable to failures to file reports with respect to certain foreign corporations under section 6038. Thus, for example, an individual who is notified of his failure to disclose with respect to a single taxable year under this provision and who takes remedial action on the 95th day after such notice is mailed incurs a penalty of $20,000 comprising the base amount of $10,000, plus $10,000 for the fraction (i.e., the five days) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed. An individual who postpones remedial action until the 181st day is subject to the maximum penalty of $50,000: the base amount of $10,000, plus $30,000 for the three 30-day periods, plus $10,000 for the fraction (i.e., the single day) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed.

To the extent the Secretary determines that the individual has an interest in one or more foreign financial assets but the individual does not provide enough information to enable the Secretary to determine the aggregate value thereof, the aggregate value of such identified foreign financial assets will be presumed to have exceeded the applicable reporting threshold for purposes of assessing the penalty.

Self-reporting on foreign financial accounts under the Bank Secrecy Act

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign trusts are required to report their foreign financial interests on an annual FBAR, which is principally governed by Title 31 of the United States Code (the "Bank Secrecy Act"). The Bank Secrecy Act has expanded beyond its original focus on large currency transactions, while retaining its broad purpose of obtaining reports with "a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings."[797] The statute was explicitly intended to provide enforcement tools necessary "to cope with the problems created by the so-called secrecy jurisdictions."[798]

As the reporting regime has expanded,[799] it has imposed reporting obligations on both financial institutions and the account holders. With respect to the latter, the obligation to report with respect to their foreign accounts is set forth in regulations promulgated pursuant to broad regulatory authority granted to the Secretary, as supplemented by other guidance. The statute specifies only that the required reports shall contain information about the identity and address of participants in a transaction or relationship; the legal capacity in which a participant is acting; the identity of real parties in interest; and a description of the transaction "in the way and to the extent the Secretary prescribes."[800] A citizen, resident, or person doing business in the United States is required to keep records and file reports when that person enters into a transaction or maintains a relationship (e.g., an account) with a foreign financial entity,[801] to the extent that the value of all assets within all such accounts in which the person has an interest exceeds $10,000 at any time during the year. The FBAR report must disclose any account in which the filer has a financial interest or as to which the filer has signature authority (in which case the filer must identify the owner of the account).

The FBAR, due by June 30 of the year following the year in which the $10,000 threshold is met,[802] is filed by mailing to the Department of the Treasury at the IRS Detroit Computing

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[797] 31 U.S.C. sec. 5311.

[798] H.R. Rep. No. 975, 91st Cong., 2d Sess. 19 (1970).

[799] E.g., Title III of the U.S.A. PATRIOT Act, Pub. L. No. 107-56 (October 26, 2001), Sections 351 through 366, amended the Bank Secrecy Act as part of a sweeping series of reforms directed at international financing of terrorism.

[800] 31 U.S.C. sec. 5314(a) states, "Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency. The records and reports shall contain the following information in the way and to the extent the Secretary prescribes," The Instructions to Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," provide greater detail on the information required to be reported.

[801] 31 U.S.C. sec. 5314.

[802] 31 C.F.R. sec. 103.27(c).

Center. Failure to file the FBAR is subject to both criminal[803] and civil penalties.[804] Since 2004, the civil sanctions have included a penalty of up to $10,000 for failures that are not willful, and a penalty of the greater of $100,000 or 50 percent of the balance in the account for willful failures. Although the form is received and processed by the IRS, it is neither part of the income tax return that the individual files with the IRS nor filed in the same office as the return. As a result, it is not considered "return information," and its distribution to other law enforcement agencies is not limited by the nondisclosure rules of the Code.[805]

Although the obligation to file an FBAR arises under Title 31, most individual taxpayers subject to the reporting requirements are alerted to the existence of the requirements when preparing annual Federal income tax returns by the questions regarding foreign bank accounts that are included in Part III of Schedule B of IRS Form 1040, "Foreign Accounts and Trusts." The responses to these questions do not in themselves discharge one's obligations under Title 31. In addition, they constitute "return information"[806] and may not be routinely disclosed to those charged with enforcing Title 31.

In October 2008, the Treasury Department and the IRS revised the form and its accompanying instructions. The revisions explained how the filing requirement applies to new types of financial transactions and attempted to ensure that transactions intended to be covered do not fall outside the literal language of the instructions. The revised instructions track the language of the statute in stating that a person in or doing business in the United States is within its purview. Thus, the revisions are arguably mere clarifications. However, questions about the extent to which the revisions expanded the FBAR filing requirements with respect to non-U.S. persons, the treatment of commingled funds and the definitions of financial interest,[807] led the IRS to announce that people may rely on earlier, unrevised instructions to determine whether they are required to file an FBAR, pending publication of guidance on the scope of the statute. In addition, the IRS granted administrative relief to persons with only signature authority over

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[803] 31 U.S.C. sec. 5322 provides that failure to file is punishable by a fine up to $250,000 and imprisonment for five years, both of which may double if the violation occurs in conjunction with certain other violations.

[804] 31 U.S.C. sec. 5321(a)(5).

[805] Section 6103 bars disclosure of return information, unless permitted by one of its numerous exceptions.

[806] Sec. 6103.

[807] The 2008 instructions defined "financial interest" to include an account held by a partnership or corporation in which a U.S. person owned, directly or indirectly, more than 50 percent of the value or control " as well as any beneficial interest in an account owned by a trust, or a person acting on behalf of a trust, if that trust was established by a U.S. person and a trust protector has been appointed to monitor the trustee's activities with authority to replace the trustee under certain specified conditions. Financial accounts for which a report may be required include credit, debit or prepaid cards, as well as accounts held by foreign individuals who do business in the United States or accounts over which a U.S. person has "signature or other authority." "Other authority" includes authority that may be indirectly exercised without need for a written instruction. The information required to be reported is explained in greater detail, including the need to disclose the highest value held by the account at any point in the year. The filing responsibilities of corporate employees with signature authority but no financial interest were also clarified.

foreign financial accounts as well as signatories or owners of a financial interest in a foreign commingled fund.[808] Proposed regulations, including newly revised instructions for the FBAR, were published in the Federal Register on February 26, 2010.[809] The proposed regulations provide new definitions of United States person, specify the types of interest that may constitute a foreign financial interest, provide special rules for persons with multiple accounts, and create an anti-avoidance rule to prevent use of an entity created for the purpose of evading the reporting requirements.

Description of Proposal

A U.S. individual would be required to report, on the individual's income tax return, any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual. Additionally, any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest would be required to report any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the entity. Such an entity would also be required to report the name, address, and taxpayer identification number of any U.S. individual with a more than 25-percent ownership interest in the entity. This reporting requirement would not apply if the cumulative amount or value of transfers, and the cumulative amount or value of receipts that would otherwise be reportable for a given year, were each less than $50,000.

The Treasury Department would receive regulatory authority to require the reporting of additional information, including classifying transfers and receipts as "for investment" or "for arm's-length payments in the ordinary course of business for services or tangible property," or such other categories as the Secretary may prescribe. The Treasury Department would also receive regulatory authority to issue rules to prevent abuse of the reporting exemptions and to provide exceptions to the reporting requirement.

The proposal also includes a penalty for failure to report a covered transfer. The failure to report as required under the proposal would result in the imposition of a penalty equal to the lesser of $10,000 per reportable transfer or 10 percent of the cumulative amount or value of the unreported covered transfers. No penalty would be imposed for a failure to report due to reasonable cause.

Effective date.−The proposal would be effective for transfers made after December 31, 2012.

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[808] Announcement 2009-51, 209-25 I.R.B. 1105 (June 5, 2009). On August 7, 2009, Notice 2009-62, 2009-35 I.R.B. extended the due date for filing an FBAR for 2008 and earlier years to June 31, 2010. On February 26, 2010, the IRS announced that non-U.S. persons may continue to rely on the instructions as in effect prior to the 2008 revision (Ann. 2010-16, I.R.B. 2010-11). On February 26, 2010, the IRS extended the suspended filing date to June 30, 2011, for calendar years 2009 for those with signatory authority only (Notice 2010-23, I.R.B. 2010-11).

[809] Fed. R. Vol. 75, No. 38. 31 C.F.R. Part 103.

Analysis

A requirement to report on one's tax return all transfers to or receipts from a foreign financial account appears to overlap significantly with the disclosure requirements of both the recently enacted section 6038D and FBAR. Because the disclosure requirements of section 6038D are not yet in effect, their effectiveness has not yet been tested. As a result, one could argue that introduction of any new self-reporting requirements is premature. It may result in reporting of information that is duplicative or of little additional value, thus increasing administrative and processing burden on the IRS, while at the same time increasing the compliance burdens on individuals who pose little risk of tax evasion.

A review of the provenance of this proposal is helpful in understanding whether it complements the recently enacted FATCA provisions. This proposal to report on transfers was included in last year's budget proposal, as one of a number of provisions intended to combat offshore tax avoidance. It was one of two provisions requiring a taxpayer to self-report foreign holdings on his Federal income tax return. The other self-reporting provision required disclosure of FBAR filings with the tax return. While other offshore compliance proposals were refined to form the nucleus of FATCA, neither of the proposals to require self-reporting with respect to foreign accounts was included in that legislation. Instead, a third version of a self-reporting requirement was crafted, and resulted in the requirement in section 6038D to disclose on Federal tax returns the value of foreign financial assets held during a taxable year, rather than transfers. FATCA was pending at the time this year's President Budget was published. In its proposals, the Administration included a new proposal for a self-reporting provision similar to that included in FATCA, as well as a revised version of last year's proposal to require reporting of transfers.

The reasons given in support of these proposals refer to concern about the use of foreign accounts by U.S. citizens and residents to evade U.S. tax, but do not explain whether the proposals should be viewed as alternative or complementary proposals. The proposals are not identical, but it is not clear the extent to which one enhances the other. With the enactment of FATCA, individuals are now required to disclose their ownership of foreign financial assets and the value of such assets. The breadth of the statutory definition of foreign financial assets under new section 6038D is significant. If the dollar value in an account or foreign instrument or entity at any time exceeds $50,000, it must be disclosed, without regard to the percentage ownership interest in the account, instrument or entity. Thus, without an exception for a de minimis ownership interest under section 6038D, that provision may require greater disclosure than this proposal, which limits reporting to those entities in which the individual holds an interest of 25 percent or more. However, the detail that this proposal requires may be significantly greater than that required by new section 6038D.

Transfers or receipts that would be required to be aggregated and disclosed in order to comply with a statute based on this proposal may relate to an asset that is also subject to reporting under section 6038D. The extent to which this proposal provides information that is not disclosed under section 6038D is difficult to determine, as is the incremental value of such information. It is possible that aggregate transfers in and out of an account may exceed $50,000 in one year, although the balance of the account at no time reaches that threshold. In such cases, this proposal would capture information that section 6038D would not. Whether the value of the nonredundant information outweighs the increased administrative complexity and problems with filtering redundant information is more difficult to determine. The extent to which reports on transfers and receipts are of value depends in part upon the ability to determine the validity of the information by comparison with another source of information, preferably a disinterested third-party information report. Without third-party information reporting on transfers and receipts, the value of an individual's report lies in the disclosure of the existence of the asset, not the volatility of transactions with respect to the asset. The proposal does not specify contemporaneous reporting of the transfers throughout the year, but annual reporting of transfers and receipts would require tracking such transactions throughout the year in order to ascertain whether a taxpayer met the threshold that triggers the reporting obligation.

In determining whether the proposal strikes an appropriate balance between the government need for information, the burden of providing such information, and possible privacy concerns, it is helpful to consider whether the proposals reach their intended targets. It would seem that high-net worth individuals, whose ability to exploit international structures to minimize tax may have a significant influence on the overall perception of the integrity of a tax system, are the intended target. By requiring reporting on both the existence of foreign assets as well as transfers, the use of complex structures to avoid the reporting threshold may be curtailed. If such persons are assumed to present a higher risk of avoidance behavior, they may fairly be viewed as appropriate targets of the enhanced reporting requirements, and the costs that higher risk taxpayers would incur in complying with the requirements may be appropriate.

Nevertheless, the reporting on transfers and receipts could result in a high volume of information of limited use to tax authorities because it is duplicative of other information reports. In addition, the proposal as currently formulated may unintentionally reach large classes of taxpayers who pose relatively little risk of tax evasion. These groups include first or second generation immigrants who send money to their families in their country of origin; beneficiaries of employee plans of multinational companies; and U.S. expatriates working overseas as employees of foreign entities and having signature authority over foreign accounts in that capacity but no financial interest in such accounts. The controversy concerning the scope of an FBAR obligation of the latter group of individuals has led to suspension of certain FBAR deadlines, pending promulgation of final regulations, as explained above,[810] but is close to resolution in the FBAR context. The Administration proposal may engender a similar controversy.

It is also not clear whether the presumption under section 6038D that an undisclosed foreign financial asset has a value of at least $50,000 dollars would automatically trigger application of the proposed reporting requirement for transfers and receipts. Under section 6038D, the $50,000-value presumption applies if the IRS learns of a foreign financial asset and is not provided information sufficient to determine whether it should have been the subject of reporting under that provision. If the 6038D presumption applied for purposes of the proposal, an asset that never had a value in excess of $50,000 during the year and with respect to which there is little activity could be subject to the requirements of the proposal in addition to a penalty under section 6038D.

[810] See footnote 853, supra, and accompanying text.

One difference from last year's proposal is the absence of an explicit exception for transfers to or from financial institutions that are parties to qualified intermediary ("QI") agreements with the IRS. Such an exception from reporting for transfers to a QI or foreign financial institutions ("FFI") with agreements under new sections 1471 and 1473 could have the effect of promoting participation in the QI program and the new FFI agreements. Investors who know of the reporting requirements may prefer to invest with a QI or compliant FFI, in order to avoid reporting, and, collectively, could exert market pressure on institutions to participate. However, if the institutions in a particular jurisdiction were to conclude that the benefits of such status were insufficient to warrant the compliance costs, or if the local jurisdiction were unable to satisfy the know-your-customer rules that are a predicate to QI approval, the option for the U.S. person in such locations may be limited to foreign financial institutions that do not report. In response to last year's proposals, Treasury received comments to the effect that investors would find it less burdensome to report all transfers than to try to determine whether a foreign entity was a QI and in compliance with its QI agreement.

Although the broad regulatory authority requested in the description could be exercised to craft such an exception, it is not clear that such an exception is intended.

Penalty proposal and stacking

The proposed penalty for failure to comply with the new reporting requirement is similar to the civil FBAR penalties applicable to non-willful failures to file in that it would generally be capped at $10,000. However, the proposed penalty differs in that it permits a lesser fine equal to 10 percent of the unreported transfer if such amount would be less than $10,000. To the extent that enacting a penalty similar to the FBAR penalties is appropriate, the use of an amount different from the applicable amounts under Title 31 is difficult to rationalize.

Nevertheless, the flexibility in determining the amount of a penalty under the proposal relieves the proposal of the chief criticism applied to the FBAR penalty, i.e., that it is often disproportionate to the offense in the case of a non-filer who appropriately reported all income related to the account for which an FBAR filing was required. In that case, the penalty can pose a significant disincentive to a person who mistakenly fails to file and subsequently wishes to take remedial action. To the extent that a taxpayer's failure to file was willful, it is doubtful that the taxpayer will undertake remedial action without some assurance of leniency.

Because the filing obligations of FBAR, new section 6038D and this proposal overlap, separate penalties under each of those provisions could apply, with the result that otherwise reasonable penalties may prove to be disproportionate in amount unless stacking of the penalties is limited or prohibited.

In recognition of these disincentives, the IRS waived the civil FBAR penalties on two previous occasions in an effort to promote settlements. First, in announcing the Offshore Voluntary Compliance Initiative in 2003[811] the IRS encouraged the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through

[811] Rev. Proc. 2003-11, sec. 2.02, 2003-1 C.B. 311.

credit card or other financial arrangements similar to those targeted by an IRS enforcement program known as the Offshore Credit Card Program. The IRS agreed to waive the civil fraud penalty and certain penalties relating to failure to file information and other returns, including the FBAR,[812] but held taxpayers liable for back taxes, interest, and certain accuracy-related and delinquency penalties.[813] Under the terms of the 2009 voluntary disclosure initiative announced by the Commissioner on March 26, 2009, the IRS proposed, in certain cases, to waive those penalties in significant part.[814] In guidance issued to field agents, the IRS instructed agents handling cases arising under the voluntary disclosure initiative to impose an "offshore penalty" in lieu of FBAR penalties to those who were not in compliance with the tax laws but voluntarily disclosed and submitted delinquent FBARs and other information returns by September 23, 2009.[815]

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.

2. Require third-party information reporting regarding the transfer of assets to or from foreign financial accounts and the establishment of foreign financial accounts

Present Law

The recently enacted Hiring Incentives to Restore Employment ("HIRE") Act[816] provides for reporting of specific information by third parties for certain U.S. accounts held in foreign financial institutions ("FFIs").[817] Information reporting is enforced through the withholding of

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[812] News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003). Taxpayers wishing to participate in the program were required to apply before April 15, 2003.

[813] Rev. Proc. 2003-11, 2003-1 C.B. 311; News Release, Internal Revenue Service, IR-2003-5 (Jan. 14, 2003); Government Accountability Office, *Testimony of Michael Brostek Before the Committee on Finance, U.S. Senate: Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions*, GAO-04-972T (Nov. 19, 2003).

[814] See Kristen A. Parillo and Jeremiah Coder, "IRS Reduces Penalties on Voluntarily Disclosed Offshore Accounts," *Tax Notes Today* 57-02 (March 27, 2009), reporting the statement from IRS Commissioner Douglas Shulman on offshore income and the release of several internal memoranda outlining the settlement conditions for those who voluntarily disclose.

[815] The amount of the offshore penalty was to equal 20 percent of the aggregate balances at their highest point in any of the six years covered by the voluntary disclosure. A delinquent FBAR filer who was otherwise in compliance with the tax laws would incur neither the FBAR penalty nor the offshore penalty.

[816] Pub. L. No. 111-147.

[817] An FFI must report the name, address, and taxpayer identification number of each U.S. account holder, the account number, the account balance or value, and, except as provided by the Secretary, the gross receipts and gross withdrawals or payments from the account.

tax on payments to FFIs unless the FFI enters into and complies with an information reporting agreement with the Secretary.[818]

The HIRE Act does not require third-party information reporting with regard to the transfer of money or property to, or receipt of money or property from, a foreign bank, brokerage, or other financial account on behalf of a U.S. person, or with regard to the establishment of a foreign bank, brokerage, or other financial account on behalf of a U.S. person.

Description of Proposal

Any U.S. financial institution that during the year transfers to, or receives from, a foreign bank, brokerage, or other financial account money or property with an aggregate value of more than $50,000 on behalf of a U.S. individual, or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest, would be required to file an information return regarding such transfer or receipt (including, in the case of a transfer by an entity, the name, address, and taxpayer identification number of any U.S. individual who owns more than 25 percent of the ownership interest in such entity). Any U.S. financial institution that opens a foreign bank, brokerage, or other financial account on behalf of a U.S. individual, or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest, would be required to file an information return with the IRS regarding such account, including reporting any amounts of money or property transferred by the financial institution to, or received by it from, such account.

In addition to filing an information return with the Internal Revenue Service, the U.S. financial institution would be required to send a copy of such return to the U.S. individual, or entity, as to which the return is made.

Reporting would not be required where the U.S. financial institution determined the entity making or receiving the transfer was: a publicly traded corporation, or a subsidiary thereof; an organization exempt from tax under section 501; an individual retirement plan; the United States or any wholly owned agency or instrumentality thereof; any State, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing; any bank (as defined in section 581); any real estate investment trust (as defined in section 856); any regulated investment company (as defined in section 851); any common trust fund (as defined in section 584(a)); any trust which is exempt from tax under section 664(c) or is described in section 4947(a)(1); or an entity engaged in an active trade or business (other than the business of investing or similar activities).

Failure to file a required information return or to provide a copy of such return to the U.S. individual would result in the imposition of a penalty of $50 with respect to each such failure. In the case of a failure to file due to intentional disregard, the penalty would be the greater of $100

[818] The information reporting requirement under the HIRE Act generally applies to payments made after December 31, 2012.

or five percent of the amount of the items required to be reported. No penalty would be imposed for a failure to report due to reasonable cause.

The Treasury Department would receive regulatory authority to provide additional exceptions (including where the Secretary determines that the reporting would be duplicative of other reporting requirements), to limit the types of transfers subject to the reporting requirement, to require that certain additional information be reported, and to permit U.S. financial institutions to report additional transfers of money or property to or from a foreign bank, brokerage, or other financial account on behalf of a U.S. individual (or on behalf of an entity of which the U.S. individual owns, actually or constructively, more than 25 percent of the ownership interest).

Effective date.–The proposal applies to amounts transferred and accounts opened beginning after December 31, 2012.

Analysis

This proposal focuses on transfers made to, or received from, a foreign financial account on behalf of a U.S. person. It is intended to give the IRS an additional line of sight to foreign financial accounts that might not otherwise be available under the other Administration proposals aimed at accounts and entities in offshore jurisdictions. This proposal provides the IRS with the ability to match the third-party information with the information required to be filed on a taxpayer's tax return under the Administration's proposal relating to transfers to or from a foreign financial account by a U.S. taxpayer. The current reporting regime for offshore financial accounts relies primarily on self-reporting, but the Administration is concerned that U.S. persons are failing to comply with these self-reporting requirements. The Administration believes that this proposal, which establishes a third-party reporting requirement with respect to transfers to or from foreign financial accounts, receipts from such accounts, and the establishment of such accounts, would lead to greater disclosure of foreign financial accounts, and consequently would discourage the evasion of U.S. taxation.

While one may agree in principle that the problem of tax evasion by U.S. individuals through the use of foreign financial accounts is serious, and that conceptually some form of third-party information reporting to the IRS may deter such evasion, one may question whether this specific provision, which requires third-party reporting on certain transfers to and receipts from a foreign financial account, is an effective and efficient solution.

By way of background, the Financial Crimes Enforcement Network, commonly known as FinCEN, is the agency within the Treasury Department responsible for patrolling the nation's financial system. Its primary purpose is to fight money laundering and terrorist financing. At the request of Congress, FinCEN studied and issued a feasibility report in 2007, discussing the building of a cross-border information reporting system that would store and report information on cross-border wire transfers.[819] The information received by this system would be provided by

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[819] Financial Crimes Enforcement Network, *Feasibility of a Cross-Border Electronic Funds Transfer Reporting System under the Bank Secrecy Act*, (Jan. 27, 2009), http://www.fincen.gov/news_room/rp/files/cross_border.html.

U.S. financial institutions that send wire transfer instructions to or receive wire transfer instructions from non-U.S. financial institutions. It could then be used by various law enforcement agencies such as the Secret Service, the Drug Enforcement Administration, the Federal Bureau of Investigation, and other U.S. intelligence agencies. The feasibility study concluded that although the construction of such a system is possible, it would cost approximately $32.6 million and take over three years to implement. To date, this reporting system has not been implemented.

Proponents of third-party information reporting of certain offshore transfers such as the Administration's proposal believe that such a system or similar system, if developed, could be used for tax information reporting purposes. The expectation is that the IRS would be able to look at the flow of funds out of the United States and see to what extent they are being sent directly to foreign accounts that may not have been properly reported. It could then identify and investigate anomalies such as disproportionate funds to one country or institution, or irregular and one-time transfers. Additionally, the IRS could link new cross-border fund transfer information with tax return information to identify suspicious activity. Moreover, this information could be used for matching purposes to determine whether the appropriate information returns, including the FBAR, were filed by the taxpayer.[820]

Various differences exist between the FinCEN proposal as contemplated and the Administration's proposal. First, the FinCEN proposal only applies to certain wire transfers, whereas this proposal applies to cross-border transfers whether or not by wire transfer. Second, the FinCEN proposal did not contemplate the need for obtaining taxpayer identification numbers for the relevant parties involved in the transfer. Such information is important to assure that reporting is of maximum usefulness for tax administration purposes. These differences would need to be bridged if a single system were to be used for tax and non-tax purposes.

Representatives of the financial services sector, however, have suggested that this proposal will generate a large volume of information reports that capture routine, legitimate business transactions of U.S. persons making payments for goods and services to foreign persons who are not subject to U.S. taxes. They have also asserted that the systems required to comply with the reporting requirements under the Administration's proposal would be even more challenging to implement than those necessary to implement the proposal studied by FinCEN. In general, the proposal studied by FinCEN required the identification of all wire transfers to or from a foreign financial account. The Administration's proposal is more complex from an administrative standpoint, because it requires the identification of a subset of all cross-border transactions. This subset of transactions would then require processing and reporting, including reporting additional information, such as taxpayer identification numbers, to the IRS.

Proponents of this and other recent similar proposals argue that some of the information necessary to meet the third-party information reporting requirements is already collected by financial institutions to facilitate compliance with anti-money laundering laws. However, these systems are not necessarily compatible. A firm's tax reporting system requires automation of as

[820] Martin Sullivan, "Economic Analysis: Proposals to Fight Offshore Tax Evasion, Part 2," *Tax Notes* (April 27, 2009), p. 371.

much information as possible; whereas information gathered in compliance with anti-money laundering laws requires significant manual processes.

Some consider the proposal's effective date (i.e., effective for amounts transferred and accounts opened beginning after December 31, 2012) ambitious, arguing that the implementation of such a third-party information reporting requirement could take several years to complete.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.

H. Reform Treatment of Insurance Companies and Products

1. Modify rules that apply to sales of life insurance contracts

Present Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[821]

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited.[822] Under the limitation, the excludable amount may not exceed the sum of: (1) the actual value of the consideration; and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if: (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract;[823] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[824]

In the case of certain accelerated death benefits and viatical settlements,[825] special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated

[821] Sec. 101(a)(1).

[822] Sec. 101(a)(2).

[823] Sec. 101(a)(2)(A).

[824] Sec. 101(a)(2)(B).

[825] Sec. 101(g).

as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts.

In Rev. Rul. 2009-13,[826] the IRS ruled that income recognized under section 72(e) on surrender of a life insurance contract with cash value to the life insurance company is ordinary income. In the case of sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain.

In Rev. Rul. 2009-14,[827] the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

Description of Proposal

The proposal imposes reporting requirements on the buyer in the case of the purchase of an existing life insurance contract with a death benefit equal to or exceeding $500,000. The proposal also imposes reporting requirements on the issuing insurance company in the case of the payment of benefits under a purchased contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is: (1) the purchase price; (2) the buyer's and seller's taxpayer identification numbers; and (3) the name of the issuer of the contract and the policy number.

When a policy benefit is paid under the contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports: (1) the gross amount of the payment; (2) the taxpayer

[826] 2009-21 I.R.B. 1029.

[827] 2009-21 I.R.B. 1031.

identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract.

In addition, the proposal modifies the present-law rules providing exceptions to the limitation on the excludable amount of a death benefit. Under the proposal, the exceptions do not apply to buyers of policies.

Effective date.–The proposal is effective for sales or assignments of interests in life insurance contracts and payments of death benefits for taxable years beginning after December 31, 2010.

Analysis

Reporting

The proposal is directed to the issue of collection of tax on amounts that are includable in income with respect to a life insurance contract that has been transferred for value. Because information about the identity of parties to transfers of contracts, amounts paid for transferred contracts, and payments under transferred contracts is not now reported, enforcement of present-law income inclusion requirements is needlessly difficult. Taxpayers who are parties to transfers of life insurance contracts may have a reduced incentive accurately to measure gain on transfers and on payments under transferred contracts, or even to include any amount in income, because they believe enforcement of the requirement of inclusion is impaired by the lack of reporting. Thus, it is argued, the reporting provisions are needed to improve voluntary compliance with present law.

Purchasers of life insurance contracts (such as viatical settlement or life settlement companies, or others that securitize purchased life insurance contracts) should not be more easily able to escape tax on their business income than other business taxpayers because enforcement may be difficult due to lack of reporting. The perception that taxpayers might not include income because enforcement of the inclusion requirement may be difficult can be corrected, advocates argue, by making it very clear that enforcement of the inclusion requirement is easy using the reported information.

Opponents of the reporting requirement may argue that the reporting requirements are burdensome. They may argue that processing and putting to use all the information that would be required by the proposal is an inefficient use of IRS resources, which might be better employed addressing other, more pressing tax issues. They may further argue that the level of detail of the reporting under the proposal is excessive, and that if any reporting of transfers of life insurance contracts is proposed, it should be more limited than that proposed. On the other hand, some might point to present-law reporting requirements applicable to banks and mutual funds, and could argue that the reporting under the proposal is no more burdensome.

The mechanics of the reporting requirement could be criticized as not fully developed. The proposal does not address the mechanism for reporting the purchase price in the case of periodic payments for the purchase of an insurance contract. On the other hand, these details could be developed either as Congress drafts the proposal, or as it is implemented by the IRS.

The reporting requirement on payment of a death benefit under a contract could also be criticized as somewhat complex, because it applies to payments with respect to only those contracts, the death benefit under which equals or exceeds $500,000. This dollar threshold requires taxpayers to distinguish among contracts for reporting purposes. If, by contrast, the reporting requirement applied to any payment under a contract, regardless of the size of the death benefit, then this determination would be eliminated, and the payor would report the taxable portion (if any) of the payment. Nevertheless, those opposed to the proposal's reporting requirements generally on the grounds that they are unduly burdensome might argue that expanding the circumstances in which reporting applies would exacerbate the problem.

Opponents might argue that it is inconsistent to modify the reporting requirements only for purchases of an existing life insurance contract with a death benefit equal to or exceeding $500,000, while modifying the exclusion rules regardless of the amount of the death benefit under the contract. If reporting is inadequate under present law, it could be argued, it should be applied to all cases in which income should be reported, not just some; or alternatively, the modifications of the exclusion rules should parallel the reporting rules, if the underreporting is principally a problem at that level of death benefits under purchased contracts.

On the other hand, most reporting requirements under present law require reporting only for amounts over a dollar threshold, and this proposal is arguably consistent with that approach.

Modifying exceptions to transfer for value rule

Opponents of the modification to the present-law exceptions may argue that the proposal is not sufficiently detailed or specific, and that a vague proposal to modify the exceptions could have a chilling effect on legitimate business transactions that are not intended to be covered by the proposal. On the other hand, it could be noted that the proposal would become specific during the legislative process, before any provision would be enacted.

The promulgation of guidance by the IRS in Rev. Ruls. 2009-13 and 2009-14 may prompt the argument that legislative change to the transfer for value rule is not needed, as these rulings address all the important open questions of determining the basis of a life insurance contract and determining the character of gain on transactions involving the contract. It is not necessary to repeal the exceptions to the transfer for value rules in the case of purchased contracts, once these issues are clarified for taxpayers.

Nevertheless, basis and character are not the issues involved in the exceptions: instead, the issue is whether gain is recognized at all. The exceptions may have arisen long ago when transfers of life insurance contracts were relatively rare and often took place among family members or owners of closely held businesses. In the past 10 or 20 years, however, an enormous and growing secondary market for life insurance contracts has developed.[828] Transfers of life

[828] See, e.g., Marc Lifsher, "Treating Death as a Commodity: A Growing Industry Involves Buying, Selling and Profiting from Life Insurance," *Los Angeles Times*, February 20, 2008, A1; Genevieve Cua, "Investing in Second-Hand Life; This Fund Pools Policies Sold by the Insured," *Business Times Singapore*, July 2, 2008, section F; Anita Juslin, "Insuring a Controversy: the Wealthy are Selling Their Life Insurance Policies for Profit," *Washington Post*, November 27, 2007, D-l.

insurance contracts are significantly more common and typically involve transactions among parties that are not family members or involved in a closely held business together. Rather, buyers of life insurance contracts are typically participants in a market for financial intermediation. The exceptions to the transfer for value rule should not apply in this context, it is argued.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposals.

2. Modify dividends received deduction for life insurance company separate accounts

Present Law

Dividends received deduction

A corporate taxpayer may partially or fully deduct dividends received.[829] The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns.

Life insurance company proration rules

A life insurance company is subject to proration rules in calculating its taxable income.

The proration rules reduce the company's deductions, including reserve deductions and dividends received deductions, if the life insurance company has tax-exempt income, deductible dividends received, or other similar untaxed income items, because deductible reserve increases can be viewed as being funded proportionately out of taxable and tax-exempt income.

Under the proration rules, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest.[830] Similarly, under the proration rules, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends,[831] but not for the policyholders' share. Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

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[829] Sec. 243 et seq. Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

[830] Secs. 807(a)(2)(B) and (b)(1)(B).

[831] Secs. 805(a)(4), 812.

The life insurance company proration rules provide that the company's share, for this purpose, means the percentage obtained by dividing the company's share of the net investment income for the taxable year by the net investment income for the taxable year.[832] Net investment income means 95 percent of gross investment income, in the case of assets held in segregated asset accounts under variable contracts, and 90 percent of gross investment income in other cases.[833]

Gross investment income includes specified items.[834] The specified items include interest (including tax-exempt interest), dividends, rents, royalties and other related specified items, short term capital gains, and trade or business income. Gross investment income does not include gain (other than short term capital gain to the extent it exceeds net long-term capital loss) that is, or is considered as, from the sale or exchange of a capital asset. Gross investment income also does not include the appreciation in the value of assets that is taken into account in computing the company's tax reserve deduction under section 817.

The company's share of net investment income, for purposes of this calculation, is the net investment income for the taxable year, reduced by the sum of (a) the policy interest for the taxable year and (b) certain policyholder dividends.[835] Policy interest is defined to include required interest at the greater of the prevailing State assumed rate or the applicable Federal rate (plus some other interest items). Present law provides that in any case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what rate or rates are appropriate for this purpose.[836]

In 2007, the IRS issued Rev. Rul. 2007-54,[837] interpreting required interest under section 812(b) to be calculated by multiplying the mean of a contract's beginning-of-year and end-of-year reserves by the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, for purposes of determining separate account reserves for variable contracts.

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[832] Sec. 812(a).

[833] Sec. 812(c).

[834] Sec. 812(d).

[835] Sec. 812(b)(1).

[836] Legislative history of section 812 mentions that the general concept that items of investment yield should be allocated between policyholders and the company was retained from prior law. H. Rep. 98-861, Conference Report to accompany H.R. 4170, the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 1065 (June 23, 1984). This concept is referred to in Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84 (December 31, 1984), 622, stating, "[u]nder the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (i.e., by reference to 'required interest')." This may imply that a reference to pre-1984-law regulations may be appropriate. See Rev. Rul. 2003-120, 2003-2 C.B. 1154, and Technical Advice Memoranda 20038008 and 200339049.

[837] 2007-38 I.R.B. 604.

However, Rev. Rul. 2007-54 was suspended by Rev. Rul. 2007-61, in which the IRS and the Treasury Department stated that the issues would more appropriately be addressed by regulation.[838] No regulations have been issued to date.

Life insurance company tax treatment of variable contracts

A variable contract is generally a life insurance (or annuity) contract whose death benefit (or annuity payout) depends explicitly on the investment return and market value of underlying assets.[839] The investment risk is generally that of the policyholder, not the insurer. The assets underlying variable contracts are maintained in separate accounts held by life insurers. These separate accounts are distinct from the insurer's general account in which it maintains assets supporting products other than variable contracts.

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[840] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule,[841] in determining reserves for variable contracts, realized and unrealized gains are subtracted, and realized and unrealized losses are added, whether or not the assets have been disposed of. The basis of assets in the separate account is increased to reflect appreciation, and reduced to reflect depreciation in value, that are taken into account in computing reserves for such contracts.

Description of Proposal

The proposal generally has the effect of reducing the amount treated as the life insurance company's share of dividends received under the proration rules in the case of a separate account. Under the proposal, amounts retained by a life insurance company are treated as derived proportionately from items included in net investment income and items not so included (such as capital gain). The result of the proposal is that the company's share of the dividends received deduction approximates the ratio of (1) the surplus (including seed money) in the separate account to (2) the total assets of the account. The amount of surplus and of total assets is determined as an annual mean for this purpose.

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

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[838] 2007-42 I.R.B.799.

[839] Section 817(d) provides a more detailed definition of a variable contract.

[840] Sec. 807.

[841] Sec. 817.

Analysis

In general

The proposal is directed towards improving the accuracy of measurement of income of life insurance companies by modifying the proration rules that limit deductions associated with untaxed income. The proposal also serves to simplify these proration rules, which are rather complex. The proposal aims to improve the clarity of the law and resolve interpretive issues that have arisen in recent years, thus reducing controversies between the IRS and taxpayers.

In analyzing the proposal, it is useful to compare the life insurer proration rules to other present-law rules limiting deductions associated with untaxed income of taxpayers other than life insurers. A further question is why the life insurance company proration rules involve such complex calculations, and whether complexity is inevitable. In addition, analysis of the proposal may be aided by examining other possible options for modifying the life insurance company proration rules.

Expenses and interest relating to tax-exempt income of taxpayers generally

For taxpayers other than insurance companies, present-law section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax (tax-exempt obligations).[842] The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations. Similarly, present law disallows a deduction for expenses allocable to tax-exempt interest income.

These present-law limitations are expressions of the concept that, under an income tax, expenses are deductible only if related to the production of income subject to tax. This policy concept is not expressed uniformly throughout the tax law, it may be observed. Examples of the failure of the tax law to match deductible expenses with taxable income can be cited, such as the allowance of home mortgage interest as a deduction though the imputed rental value of residence in the home is not includable in income for individuals. However, these instances may reflect nontax social policies that are implemented through the tax law, practical difficulties of valuation or administrability, or historical norms that are broadly accepted even though inconsistent with fundamental tax policy. The proration rule applicable to property and casualty insurers could also be cited as perhaps a partial failure to match deductible expenses with taxable income. That rule disallows a deduction for expenses of earning untaxed income at a flat 15 percent rate. If untaxed income represents more than 15 percent of after-tax income, the rule may not operate effectively to prevent tax arbitrage.[843] On the other hand, the two insurance company proration

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[842] Sec. 265. A pro rata interest expense allocation rule applies in the case of financial institutions, and exceptions to the general rule apply in the case of certain types of tax-exempt obligations (sec. 265(b)).

[843] For a discussion of a proposal to modify the property and casualty insurer proration rule, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal*, JCS-2-00, March 6, 2000, 425-428.

rules, because of their different operation as currently structured, are not necessarily connected. It may be argued that the proposal to modify the life insurance proration rule does not necessarily implicate the other rule, is consistent with the corresponding broadly applicable rule of section 265, and is in line with fundamental income tax policy concepts.

Historical background

In general

Proration rules limiting deductions associated with untaxed income of life insurance companies were adopted as part of the earliest Federal income tax rules applicable to life insurers in 1921.[844] Those rules required that the reserve deduction for investment income be reduced by tax-exempt interest. In 1928, however, the Supreme Court held that this deduction limitation rule was unconstitutional because it indirectly imposed Federal tax on State obligations.[845]

In subsequent legislation, the proration rule was restructured,[846] and ultimately in 1959 a further revised proration rule was adopted providing that taxable investment yield of a life insurance company was reduced by the company's share of tax-exempt interest and deductible dividends received.[847] The 1959 provision included the notions of required interest and an amount retained by the company in determining the company's share of investment income for separate accounts. More generally, the 1959 Act provided for a three-phase system of taxation of life insurers, under which, generally, gain from operations was taxed only if it exceeded the company's taxable investment income. The rules for taxing life insurance companies were substantially revised in 1984 to eliminate the three-phase system and generally to tax both operating income and investment income.[848] The 1984 revisions retained proration rules for life insurers, and generally retained the 1959 notion that the proration rules are based on a determination of the company's share of income and deductions.

[844] Sec. 245(a)(2) of the Revenue Act of 1921, Pub. L. No. 67-98, 67th Cong. 2d Sess., ch. 136, 42 Stat. 227.

[845] *National Life Insurance Company v. U.S.*, 277 U.S. 508 (1928), in which the Court relied on "settled doctrine that directly to tax the income from securities amounts to taxation of the securities themselves," and held that "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others."

[846] Sec. 163 of the Revenue Act of 1942, Pub. L. No. 77-753, 77th Cong. 2d Sess., enacting section 202(b) of the Internal Revenue Code (1942), 56 Stat. 798, 899. See also Letter of Walter C. Welsh, Executive Vice President, and William Elwell, Senior Counsel, American Counsel of Life Insurers, to the Honorable Eric Solomon, Assistant Secretary for Tax Policy, U.S. Treasury Department, and the Honorable Donald L. Korb, Chief Counsel, Internal Revenue Service, June 26, 2008, at 5-6, and Harold Wurzel, "Tax-Exempt Interest of Life Insurance Companies: A Study in 'Discriminatory' Taxation, 70 *Yale Law Journal* 15 (1960).

[847] Sec. 801, as enacted in the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 86th Cong., 1st Sess.

[848] See Title II, Life Insurance Provisions, Deficit Reduction Act of 1984, Pub. L. No. 98-369, July 18, 1984.

In 1988, the Supreme Court held that imposing Federal tax on interest earned on State bonds does not violate the intergovernmental tax immunity doctrine, and so is not unconstitutional.[849] The life insurance company proration rules have not been substantially modified since the 1988 Supreme Court decision.

The current proration formula may provide a benefit independent of the amount of any reserve deduction or tax-exempt interest and deductible dividend income because of the way the calculation treats investment expenses. The company's share increases when the actual net investment income is less than the statutorily defined net investment income. That is, a company receives a benefit from the proration rules for a separate account if the amount retained by the company is greater than five percent of defined gross investment income. This may be particularly true of separate accounts that attribute more of their appreciation to items excluded from the definition of gross investment income, such as capital gains.

<u>Sources of complexity</u>

It could be argued that the complexity of the rules and the calculations under the life insurance company proration provisions is largely attributable to the origin of the rules over 90 years ago and Congress' multiple attempts during the period to express tax policy in a manner that did not violate Constitutional doctrine. The complexity of the current proration rules may be exacerbated by the application of a few details of the 1959 Act three-phase system under modern rules shorn of that context.

The company's share served multiple purposes under the 1959 Act. It served to prorate the deduction for tax-exempt interest and dividends received as under present law. It also determined the amount of taxable investment yield included in taxable investment income. While an increase in the company's share under present law necessarily lowers taxable income, an increase in the company's share under prior law had a differing effect on taxable income depending on whether a company's gain from operations exceeded taxable investment income and the importance of tax-exempt interest and deductible dividends in investment yield.

Similarly, under the 1959 Act, gross investment income served multiple purposes. Not only did it determine the company's share for proration, but also it provided the basis for calculation of investment yield and taxable investment income. Gross investment income includes only positive ordinary income items, perhaps to avoid having to interpret and allocate negative amounts. It may be argued that the selection of items included in the current definition of gross investment income stem primarily from this function under prior law, rather than the present law proration function, and that the definition of gross investment income should now be tailored to mesh with the proration rule where it is used today.

Furthermore, retention of the 1959 Act concepts arguably is no longer necessitated by concern for potential unconstitutionality. The Federal income tax policy not to allow a deduction for expenses of earning amounts that are not included in income could be expressed more simply in the life insurance tax rules. An explicit statutory statement of the operation of the proration of

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[849] *South Carolina v. Baker*, 485 U.S. 505, *reh'g denied*, 486 U.S. 1062 (1988).

the dividends received deduction would be simplifying. Administrability of the law would be enhanced, and disputes would be reduced, if reliance on arcane, layered pre-1984 regulations were no longer an interpretive option.

If the problem is incorrect or aggressive taxpayer positions under the proration rule (as under any present-law rule), the IRS can address this through enforcement action. If this is the situation, perhaps legislative change is not needed. To the extent that the problem arises from aggressive interpretation of the current rules, it could be countered that a case by case approach, potentially leading to the expense of litigating each taxpayer's case, may be an inefficient use of government and taxpayer resources, without effectively clarifying the law in all circuits or giving a near-term answer to all taxpayers.

Nevertheless, enforcement of the law may not be the sole or even the principal issue: rather, clarification of, or change to, the law arguably is needed to eliminate uncertainty about how to determine interest when present law refers to "another appropriate rate" (in the flush language of section 812(b)(2)). In short, a change is needed to the legislative language to state a clear rule. Alternatively, Treasury Department guidance is needed to clarify application of the current rules.[850] However, further administrative guidance may be viewed as insufficient or inadequate without a legislative pronouncement of the rules.

Operation of the proposal

The proposal could be criticized as insufficiently detailed; however, a response is that the result of the proposal is clearly stated to be that the company's share of the dividends received deduction approximates the ratio of (1) the surplus (including seed money) in the separate account to (2) the total assets of the account.

On substantive grounds, an arguably simpler and more rational proposal might be to eliminate more of the pieces of the present-law rules that were imported from pre-1984 law. Under this type of approach, one option would be to eliminate the investment income-base rules of section 812, and to substitute a proration rule for life insurance company separate accounts stating that the ratio of (1) mean surplus in the account to (2) mean assets in the account[851] determines the company's share of the dividends received deduction with respect to the separate account. Under this approach, the earnings rate of the separate account would not be a part of

[850] Arguably, the rules were relatively clear − if complex − prior to the 2003 IRS issuance of TAMs that addressed some issues but left others open and the subsequent issuance and suspension of Rev. Rul. 2007-54 which set forth a different approach. It is possible that these developments served to fuel disputes between the IRS and taxpayers based on differing interpretations of the law. *See* Susan J. Hotine, "Proration for Segregated Asset Accounts − How is the Company's Share Computed?," 3 *Taxing Times* 1 (September 2007); Richard N. Bush and Greg L. Stephenson, "Separate Account DRD Under Attack: Five Decades of Practice Regarding Company Share Computation Ignored," *The Insurance Tax Review* 39 (January 2008); and Susan J. Hotine, "Proration for Segregated Asset Accounts − Part Two," 4 *Taxing Times* 21 (February 2008).

[851] Another way of stating this ratio could be: (1) assets in the account that exceed mean reserves for the account, divided by (2) assets in the account. If applied to the life insurance company general account, the ratio could be: (1) assets in the general account that exceed mean reserves for the general account, divided by (2) assets in the general account.

the calculation. Rather, the ratio would be based on assets, not earnings, of the separate account. Using this simple formula makes amounts retained, as well as investment expenses, or any other reduction to investment income, irrelevant. The company's share would reflect the company's economic interest in the separate account assets, but would not include any portion of the policyholder's economic interest. Under this approach, the company would receive the tax benefits to which it is entitled under the economic arrangement of the separate account.

While it could be argued that the proposal could motivate taxpayers to shuffle assets between the separate account and the general account to maximize the Federal tax benefit, current State regulatory rules prevent shifting of assets (or income from assets) between separate accounts, or between a separate account and the general account of a life insurer. However, a life insurer could respond by charging higher fees for separate account products or by changing its product offerings.

Another option could be to require proration only for separate accounts, not for general accounts. The obligation of the life insurer to policyholders of general account products is more attenuated than its obligation to credit separate account dividends received directly to variable contracts. Thus, perhaps like other corporate taxpayers that are not required to prorate their deduction for dividends received, the general account of life insurers arguably should not be subject to proration. Because life insurers tend to have a relatively low proportion of dividend-paying assets in the general account, imposing a complex proration rule on general account assets may not be worthwhile.

On the other hand, money is fungible, and proration of untaxed income is appropriate in any case in which the insurer has a reserve deduction with respect to amounts ultimately payable to a policyholder. Further, under present law, no dividends received deduction is allowed to corporate taxpayers for any dividend to the extent the taxpayer is under an obligation to make related payments with respect to similar property.[852] Thus, the concept exists outside the insurance context.

A possible criticism of the proposal, or of any proposal that reduces deductions pursuant to a change in the proration rule with respect to separate account products, is that the price of the products could increase. The insurer could pass some or all of the increased tax cost through to shareholders, employees, or customers. In fact, if the proration rule does not accurately measure the insurer's income by allowing either too great, or too little, a deduction, the company can share with product purchasers, or pass along to purchasers, the unintended benefit or detriment of income mismeasurement. If it is not intended to provide either a Federal tax subsidy, or an excessive tax burden, that would affect the price of separate account products of insurance companies, then improving the accuracy and administrability of the life insurance proration rule is a desirable improvement in the tax law.

[852] Sec. 246(c)(1)(B) provides that no dividends received deduction is allowed in respect of any dividend to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Taxpayers may argue, on horizontal equity grounds, that the proration rules for life insurance companies should not give rise to any reduction in the dividends received deduction, by analogy to nonlife corporations that are not subject to any rule reducing their dividends received deduction. On the other hand, dividend income of life insurance companies is arguably most analogous to operating income of nonfinancial-intermediation businesses. The normal rationale for the dividends received deduction − that it eliminates multiple applications of tax on the same income items while they remain in corporate solution − does not apply if the business the firm engages in includes the earning of dividends on the customers' behalf. Under this view, no portion of the dividends received deduction should be allowed for what is effectively business income or operating income.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.

3. Expand pro rata interest expense disallowance for company-owned life insurance ("COLI")

Present Law

Inside buildup and death benefits under life insurance contracts generally tax-free

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[853] ("inside buildup").[854] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[855]

[853] By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[854] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[855] Sec. 101(a).

Premium and interest deduction limitations with respect to life insurance contracts

Premiums

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[856]

Interest paid or accrued with respect to the contract[857]

In addition, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual,[858] with a key person insurance exception.[859]

Pro rata interest deduction limitation

A pro rata interest deduction disallowance rule also applies. This rule applies to interest, a deduction for which is not disallowed under the other interest deduction disallowance rules relating to life insurance, for example, interest on third-party debt that is not with respect to a life insurance, endowment or annuity contract. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[860] Interest expense is allocable to

[856] Sec. 264(a)(1).

[857] Earlier-enacted interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts, known as the "single premium" and "4-out-of-7" limitations. The single premium limitation provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract (Sec. 264(a)(2)). Under the general rule to which the 4-out-of-7 limitation is a safe harbor, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise) (Sec. 264(a)(3)). Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven year period is paid by means of such debt.

[858] Sec. 264(a)(4).

[859] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise deductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. The deductible interest may not exceed the amount determined by applying a rate based on Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.

[860] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is an employee or is an officer, director, or 20-percent owner of the entity of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

In 2006, additional rules for excludability of death benefits under a life insurance contract were added in the case of employer-owned life insurance contracts[861] (generally, those contracts insuring employees that are excepted from the pro rata interest deduction limitation). These rules permit an employer to exclude the death benefit under a contract insuring the life of an employee if the insured was an employee at any time during the 12-month period before his or her death, or if the insured is among the highest paid 35 percent of all employees. Notice and consent requirements must be satisfied.

Description of Proposal

The proposal eliminates the exception under the pro rata interest deduction disallowance rule for employees, officers and directors. The exception for 20-percent owners is retained, however.

Effective date.−The proposal is effective for contracts issued after December 31, 2010.

Analysis

The proposal is directed to the issue of borrowing against life insurance contracts to achieve tax arbitrage. Businesses that own life insurance on employees and borrow from a third-party lender or from the public can achieve tax arbitrage by deducting interest that funds the tax-free inside buildup on the life insurance (or the tax-deferred inside buildup of annuity and endowment contracts). This opportunity for tax arbitrage results from the exception under the pro rata interest deduction limitation for insurance covering employees and others, it is argued. This tax arbitrage opportunity is being utilized particularly by financial intermediation businesses which often have a relatively large amount of debt in the ordinary course of business. Thus, it is argued, the exception should be repealed.

Some would point to the 2006 legislation as having addressed any undesirable aspects of company-owned life insurance ("COLI"), obviating any need for further tax legislation. By adding a notice and consent requirement, the 2006 legislation removed the risk that insured employees would never know that they were insured by their employers. Similarly, the 2006 requirement that the insured must have been an employee within 12 months before death for the

[861] Sec. 101(j).

employer to be able to exclude from income the death benefit received means that there would no longer be a huge pool of former employees in whose lives the employer has a financial interest. Lastly, because the pool of employees that can be insured is limited to the highest paid 35 percent if the employer is to exclude the death benefits under the policies, the employer has no incentive to insure individuals who are not central to the operation of the business but may be lower paid, fungible workers whose life the employer has little incentive to protect. Due to these limitations on excludable death benefits under employer COLI, it is argued, there is no longer a need to resuscitate the 1999 proposal, which was made shortly after the perception that the 1996 and 1997 legislation had failed to stem the growth of COLI but before the improvements made by the 2006 legislation. Similarly, some might argue that the 1999 proposal was previously rejected (or, certainly, not adopted) by Congress, and that it is not appropriate to continue to raise it.

On the other hand, it could be asserted that the 2006 improvements do not address the tax policy issue of tax arbitrage. The tax policy issue of COLI, it is argued, is the tax arbitrage opportunity it creates to deduct expenses such as interest with respect to tax-free inside buildup of life insurance contracts. The allowance of deductible expenses with respect to untaxed income is inconsistent with the concept of an income tax. While social policy benefits arise from the 2006 legislation limiting employer opportunities to collect death benefits on insured individuals whom the employer has no economic incentive to protect, it can be argued that the tax arbitrage effect of COLI remains to be addressed.

Proponents of the proposal also point out that the 2006 legislation may not serve as a practical limitation on the overall amount of COLI that any particular taxpayer acquires. Limiting the group of individuals that may be insured generally to 35 percent of the employer's workforce arguably creates an incentive to insure each covered individual for a larger amount than without such a limitation, but may have little impact on the overall face amount of life insurance that an employer can maintain on its books. Rather, as a practical matter, the face amount of life insurance of the employer is limited by the underwriting practices of the insurer. Thus, it is argued, the 2006 legislation has not slowed the growth of COLI.[862]

The proposal could be criticized on the grounds that it fails to take into account the concern that retaining an exception from the pro rata interest disallowance rule for employees, officers, and directors is important for small businesses. Small businesses might argue that they need access to cash, in particular the cash value of life insurance on key employees, and that it would be inappropriate to reduce the tax subsidy stemming from the exception in their case, regardless of the application of the proposal to others. A more targeted proposal, whether limited to financial intermediaries or to large employers, or alternatively a narrower employee

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[862] A 2008 study shows that COLI held by banks grew to $126.1 billion in 2008, an increase of five percent from $120.1 billion in 2007. Darla Mercado, "Survey: Bank-owned life insurance assets hit $126B in '08," *Investment News.com,* June 23, 2009*; and see* Ellen E. Schultz, "Banks Use Life Insurance to Fund Bonuses – Controversial Policies on Employees Pay for Executive Benefits, Help Companies With Taxes," *Wall Street Journal*, May 20, 2009, C1. The study referred to in the Mercado article does not account for COLI that may be held by financial institutions other than banks or by other types of businesses.

exception structured like the 20-key-person exception under the 1996 legislation, might address the tax arbitrage concern without negatively impacting the cash needs of small business.

On the other hand, it could be countered that in most cases the cash needs of small businesses have already been addressed by the proposal's continuation of the exception for 20-percent owners. In addition, it can be argued that insuring the lives of key employees can be accomplished by purchasing term life insurance, which is not affected by the proposal, and that cash needs arising from loss of a key employee can be addressed without the purchase of cash value life insurance. Further, because of the extension of the average person's expected life span in recent decades, it is argued that the purchase of term life insurance on a key employee through his or her likely retirement age is no longer difficult or expensive.

Opponents of the proposal argue that the funds borrowed under the life insurance contracts are used for tax-advantaged pre-funding of expenses such as retiree health benefits and supplemental pension benefits. Congress has already provided special tax-favored treatment specifically to encourage businesses to provide health and pension benefits. It was not intended that tax arbitrage with respect to investments in COLI be used to circumvent statutory limits that Congress enacted for these tax-favored health and pension benefits, it is argued. Further, the assertion that particular sources of funds are used by corporations for particular expenses can be countered by pointing out that money is fungible.

A related argument is that COLI is accepted as tier 1 capital for banks, an important incentive for banks to hold COLI, and that limiting its tax advantages negatively impacts these financial institutions. Arguably, limiting this source of tier 1 capital may be a particularly inappropriate side effect of the proposal at the current time of economic downturn, illiquidity, unavailability of credit, and instability among some banks. Conceivably the proposal is inconsistent with efforts of the Federal government to stabilize and temporarily provide capital to the financial sector. On the other hand, it could be questioned whether a heavy investment in life insurance is a stabilizing influence on bank capital. Further, these nontax policy arguments could be criticized as unrelated to the tax policy issue addressed by the proposal.

Some might criticize the proposal as somewhat ineffective because it would not impose any dollar limitation on the amount of insurance an employer would be permitted to purchase with respect to a 20-percent owner, nor on the amount of interest expense allocable to unborrowed policy cash values with respect to such insurance that would remain deductible under the proposal. It could be argued that the proposal would not effectively deter undesirable tax arbitrage in many cases, without any such limitations.[863] On the other hand, it could be argued that State law concepts of insurable interest could operate as limits (but some might say these concepts would not impose any significant limit). It could also be argued that businesses with 20-percent owners might tend to be small businesses, and that encouraging the economic

[863] Some might go so far as to assert that, short of a rule that borrowing against life insurance value is a taxable receipt of the value borrowed, the tax arbitrage opportunity of tax-free inside buildup cannot be effectively addressed. Such a rule would be similar to section 956(c)(1)(C), for example, which provides that if a U.S. multinational borrows from its foreign subsidiary, the U.S. entity is subject to tax as if it had repatriated the (otherwise untaxed) foreign earnings.

success of small businesses is more important than limiting their tax arbitrage opportunities. Some might respond that a test based on the ownership percentage of shareholders is not actually targeted to small businesses, and that a more appropriate test would be focused on the assets or income of the business. Another response might be that 20-percent owners do not necessarily have any connection to the business, so the death of such a person might have no significant impact that would create a business need to insure the person's life. Further, it could be argued that any tax incentives provided to a sector of the economy, such as small business, should not be structured as arbitrage opportunities denied to other taxpayers, but rather as positive incentives towards socially or economically desirable goals.

Prior Action

A similar proposal was included in the President's fiscal year 1999, 2000, 2001, and 2010 budget proposals.

4. Permit partial annuitization of a nonqualified annuity contract

Present Law

Treatment of annuity contracts

In general, earnings and gains on a deferred annuity contract are not subject to tax during the deferral period in the hands of the holder of the contract.[864] When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received as an annuity (generally, as periodic payments under contract terms) or not.[865]

For amounts received as an annuity by an individual, an exclusion ratio is provided for determining the taxable portion of each payment.[866] The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the contract's annuity starting date. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract. Section 72 uses the term "investment in the contract" in lieu of the more generally applicable term "basis."

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[864] If an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[865] Sec. 72.

[866] Sec. 72(b).

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date, and are included in income to the extent allocable to income on the contract if received before the annuity starting date (i.e., as income first).[867]

Specific rules for recovering the investment in the contract for amounts received as an annuity are provided for plans qualified under section 401(a), plans described in section 403(a), and section 403(b) tax-deferred annuities.[868] In addition, specific rules apply to amounts not received as an annuity under these plans and individual retirement plans.[869]

Tax-free exchanges of annuity contracts

Present law provides for the exchange of certain insurance contracts without recognition of gain or loss.[870] No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract or for a qualified long-term care insurance contract; or (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract or for a qualified long-term care insurance contract; (3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or (4) a qualified long-term care insurance contract for a qualified long-term care insurance contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged.[871]

In interpreting section 1035, case law holds that an exchange of a portion of an annuity contract for another annuity contract qualifies as a tax-free exchange.[872] Treasury guidance provides rules for determining whether a direct transfer of a portion of the cash surrender value of an annuity contract for a second annuity contract qualifies as a section 1035 tax-free exchange. Under the Treasury guidance, either the annuity contract received, or the contract partially exchanged, in the tax-free exchange may be annuitized without jeopardizing the tax-free

[867] Sec. 72(e). By contrast to distributions under an annuity contract, distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[868] Sec. 72(d).

[869] Sec. 72(e)(8).

[870] Sec. 1035.

[871] Sec. 1031(d).

[872] *Conway v. Comm'r*, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi.

exchange (or amounts withdrawn from it or received in surrender of it) after the period ending 12 months from the receipt of the premium in the exchange.[873]

Description of Proposal

The proposal permits a part of an annuity contract to be annuitized while the balance is not annuitized.

Under the proposal, an exclusion ratio applies to each amount received as an annuity in a partial annuitization of the contract. Thus, the portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed; the taxable portion of each payment is ordinary income.

Partial annuitization is permitted only if several requirements are met. The requirements are that (1) the taxpayer irrevocably elects to apply a portion of the contract to purchase a stream of annuity payments; (2) the stream of annuity payments is either for at least ten years or for the life of one or more individuals; and (3) the exclusion ratio is computed based on the expected return and investment in the contract with regard to the portion of the contract that is annuitized.

The provision is not intended to change the present-law rules with respect either to amounts received as an annuity, or to amounts not received as an annuity, in the case of plans qualified under section 401(a), plans described in section 403(a), section 403(b) tax-deferred annuities, or individual retirement plans.

Effective date.−The proposal is effective for partial annuitizations effected after December 31, 2010.

Analysis

The proposal is based on the rationale that present law already permits a partial exchange of an annuity contract, followed (more than 12 months later) by annuitization of either annuity contract involved in the exchange. Present law does not specifically address a partial annuitization of an annuity contract that has not been involved in a tax-free exchange, however. The proposal treats these two annuitizations consistently and applies the present-law exclusion ratio to annuity payments in each case.

Consistent tax treatment eliminates uncertainty and removes the lock-in effect caused by the potential application of less favorable tax treatment to annuity payments in a partial annuitization under present law (i.e., income first treatment rather than exclusion ratio treatment). Arguably, the consistent treatment provided under the proposal serves to make the

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[873] Rev. Proc. 2008-24, 2008-13 I.R.B. 684. The Rev. Proc. further provides that a transfer does not, however, qualify as a tax-free exchange if the payment is a distribution that is part of a series of substantially equal periodic payments, or if the payment is a distribution under an immediate annuity. The Treasury guidance further provides that if a direct transfer of a portion of an annuity contract for a second annuity contract does not qualify as a tax-free exchange under section 1035, it is treated as a taxable distribution followed by a payment for the second contract.

tax law neutral as to economically equivalent forms of annuitization transactions, promoting efficiency and reducing the likelihood of tax-induced distortions of taxpayer behavior.

The change in the tax law under the proposal would make it easier for a taxpayer to choose to annuitize at least some portion of his or her contract, while at the same time preserving the corpus of the rest of the contract and preserving it for other purposes, such as future distributions, future annuitization, or a legacy for heirs on death of the annuitant. Under present law, if annuitization of a portion of a contract is less attractive for tax reasons, individuals may annuitize none of the contract rather than annuitizing and risking losing the amount of the corpus remaining on the annuitant's death. As a practical matter, the proposal increases the flexibility and utility of annuity contracts as both a source of retirement income and a means of transferring financial value to heirs.

On the other hand, the proposal could be criticized as providing further tax benefits to an already tax-favored product. Annuity contracts are not limited to use for retirement income and are not subject to the restrictions on contributions and benefits that Congress has imposed on tax-favored retirement savings. Thus, it could be argued, the proposal is inconsistent with the retirement savings policy expressed in present-law tax rules governing retirement contributions and benefits. Therefore, the proposal is perhaps unnecessarily generous for taxpayers who may already have attained maximum levels of retirement contributions and benefits. Arguably, tax incentives to save for retirement are not needed for such individuals, and could be considered a windfall to the extent the tax incentives do not induce incremental savings for retirement.

Nevertheless, because present law already permits annuitization of partially exchanged annuity contracts, failure to provide consistent tax treatment for partial annuitizations of annuity contracts that were not exchanged is inefficient and irrational. A much larger change to the tax law would be required to address the potential windfall effect of tax-favored annuity contracts in the case of taxpayers who have attained maximum levels of retirement contracts and benefits. Therefore, it is argued, short of that change, fairness and efficiency are served by treating economically equivalent annuitization transactions similarly for Federal income tax purposes.

The proposal includes the requirement that the stream of annuity payments must be either for at least ten years or for the life of one or more individuals. The tax-favored status of annuity contracts arguably could be supported by the notion that the contract serves an income replacement purpose and protects against outliving one's assets, rather than simply permitting tax-free deferral of investment earnings. This rationale has been invoked to support the idea that annuity contracts should be tax-favored only if they involve significant life contingencies.[874] It could nevertheless be argued that requiring a long payout period is overly restrictive. Under this

[874] See, e.g., Department of the Treasury, *Report to The Congress on the Taxation of Life Insurance Company Products*, March 1990, a study required by the Technical and Miscellaneous Revenue Act of 1988. The policy options presented in the report include the option to "eliminate tax-advantaged treatment of nonqualified 'annuities' without significant life contingencies," stating, "Tax-favored treatment of annuities that provide protection against outliving one's assets would be continued. Most annuities, however, guarantee a large portion, if not all of the investment income without regard to the life expectancy of the annuitant. Such an investment is economically identical to alternative taxable investments offered by other financial institutions." *Report* at 3.

view, these parties should be allowed to set a shorter payout period on the assumption that the parties can determine a payout period reasonably related to protection against outliving one's assets.

Prior Action

No prior action.

I. Eliminate Fossil Fuel Tax Preferences

Present Law

In general

The Code provides a number of tax incentives that increase the after-tax return on investment in fossil fuel production projects.

Oil and natural gas production

Incentives for the production of oil and natural gas include the enhanced oil recovery credit, the marginal wells credit, the expensing of intangible drilling costs, the deduction for using tertiary injectants, the passive loss exemption for working interests in oil and gas properties, percentage depletion, the domestic manufacturing deduction for oil and gas production, and accelerated amortization for geological and geophysical expenses.

Some of these incentives are available to all domestic producers and all domestic production, while others target smaller producers or production that utilizes specific types of extractive technologies. Some of the incentives are not available (or are only partially available) to oil and gas producers whose production activities are integrated with refining and retail sales activities.[875]

Coal and other hard mineral fossil fuel production

Incentives for the production of coal and other hard mineral fossil fuels include expensing of exploration and development costs, percentage depletion, capital gains treatment for certain royalties, and the domestic manufacturing deduction.

Credit for enhanced oil recovery costs (sec. 43)

Taxpayers may claim a credit equal to 15 percent of qualified enhanced oil recovery ("EOR") costs.[876] Qualified EOR costs consist of the following designated expenses associated with an EOR project: (1) amounts paid for depreciable tangible property; (2) intangible drilling and development expenses; (3) tertiary injectant expenses; and (4) construction costs for certain Alaskan natural gas treatment facilities. An EOR project is generally a project that involves increasing the amount of recoverable domestic crude oil through the use of one or more tertiary recovery methods (as defined in section 193(b)(3)), such as injecting steam or carbon dioxide into a well to effect oil displacement.

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[875] Integrated oil companies subject to these limitations are oil and gas producers that sell more than $5 million of retail product per year or refine more than 75,000 barrels of oil per year. Major integrated oil companies are a subset of integrated oil companies that (1) have average daily worldwide production exceeding 500,000 barrels per year, (2) had gross receipts in excess of $1 billion in 2005, and (3) own at least a 15 percent interest in a refinery that produces more than 75,000 barrels of oil per year.

[876] Sec. 43.

The EOR credit is ratably reduced over a $6 phase-out range when the reference price for domestic crude oil exceeds $28 per barrel (adjusted for inflation after 1991). The reference price is determined based on the annual average price of domestic crude oil for the calendar year preceding the calendar year in which the taxable year begins.[877] The EOR credit is currently phased-out.

Taxpayers claiming the EOR credit must reduce by the amount of the credit any otherwise allowable deductions associated with EOR costs. In addition, to the extent a property's basis would otherwise be increased by any EOR costs, such basis is reduced by the amount of the EOR credit.

Marginal well tax credit (sec. 45I)

The Code provides a $3-per-barrel credit (adjusted for inflation) for the production of crude oil and a $0.50-per-1,000-cubic-feet credit (also adjusted for inflation) for the production of qualified natural gas. In both cases, the credit is available only for domestic production from a "qualified marginal well."

A qualified marginal well is defined as a domestic well: (1) production from which is treated as marginal production for purposes of the Code percentage depletion rules; or (2) that during the taxable year had average daily production of not more than 25 barrel equivalents and produces water at a rate of not less than 95 percent of total well effluent. The maximum amount of production on which a credit may be claimed is 1,095 barrels or barrel equivalents.

The credit is not available if the reference price of oil exceeds $18 ($2.00 for natural gas). The credit is reduced proportionately for reference prices between $15 and $18 ($1.67 and $2.00 for natural gas). Currently the credit is phased out completely.

In the case of production from a qualified marginal well which is eligible for the credit allowed under section 45K for the taxable year, no marginal well credit is allowable unless the taxpayer elects not to claim the credit under section 45K with respect to the well. The section 45K credit is currently expired with respect to qualified natural gas and oil production. The credit is treated as a general business credit. Unused credits can be carried back for up to five years rather than the generally applicable carryback period of one year.

Expensing of intangible drilling costs (sec. 263(c))

The Code provides special rules for the treatment of intangible drilling and development costs ("IDCs"). Under these special rules, an operator or working interest owner[878] that pays or

[877] Secs. 43(b) and 45K(d)(2)(C).

[878] An operator or working interest owner is defined as a person that holds an operating or working interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting operating or working rights.

incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs.[879]

IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract. Such work includes labor, fuel, repairs, hauling, and supplies which are used (1) in the drilling, shooting, and cleaning of wells; (2) in the clearing of ground, draining, road making, surveying, and geological works as necessary in preparation for the drilling of wells; and (3) in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items that have a salvage value (such as pipes and casings) or items that are part of the acquisition price of an interest in the property.[880] They also do not include (1) the cost to operators payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and (2) amounts properly allocable to the cost of depreciable property.

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. In the case of a nonproductive well ("dry hole"), IDCs may be deducted at the election of the operator.[881] For an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.[882]

Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred.[883] This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. The election allows a taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax ("AMT").

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[879] Sec. 263(c).

[880] Treas. Reg. sec. 1.612-4(a).

[881] Treas. Reg. sec. 1.612-4(b)(4).

[882] Sec. 291(b)(1)(A). The IRS has ruled that, if a company that has capitalized and begun to amortize IDCs over a 60-month period pursuant to section 291 ceases to be an integrated oil company, it may not immediately write off the unamortized portion of the capitalized IDCs, but instead must continue to amortize the IDCs so capitalized over the 60-month amortization period. Rev. Rul. 93-26, 1993-1 C.B. 50.

[883] Sec. 59(e)(1).

The election to deduct IDCs applies only to those IDCs associated with domestic properties.[884] For this purpose, the United States includes certain wells drilled offshore.[885]

Pursuant to a special exception, the uniform capitalization rules do not apply to IDCs incurred with respect to oil or gas wells that are otherwise deductible under the Code.[886]

Deduction for qualified tertiary injectant expenses (sec. 193)

Taxpayers engaged in petroleum extraction activities may generally deduct qualified tertiary injectant expenses incurred while applying a tertiary recovery method, including carbon dioxide augmented waterflooding and immiscible carbon dioxide displacement.[887] The deduction is available even if such costs are otherwise subject to capitalization. The deduction is permitted for the later of – (1) the tax year in which the injectant is injected or (2) the tax year in which the expenses are paid or incurred.[888] No deduction is permitted for expenditures for which a taxpayer has elected to deduct such costs under section 263(c) (intangible drilling costs) or if a deduction is allowed for such amounts under any other income tax provision.[889]

A "qualified tertiary injectant expense" is defined as any cost paid or incurred for any tertiary injectant (other than a recoverable hydrocarbon injectant) which is used as part of a tertiary recovery method.[890] The cost of a recoverable hydrocarbon injectant (which includes natural gas, crude oil and any other injectant with more than an insignificant amount of natural

[884] In the case of IDCs paid or incurred with respect to an oil or gas well located outside of the United States, the costs, at the election of the taxpayer, are either (1) included in adjusted basis for purposes of computing the amount of any deduction allowable for cost depletion or (2) capitalized and amortized ratably over a 10-year period beginning with the taxable year such costs were paid or incurred (sec. 263(i)).

[885] The term "United States" for this purpose includes the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources (i.e., the Continental Shelf area) (sec. 638).

[886] Sec. 263A(c)(3).

[887] Sec. 193. Prior to the enactment of section 193, the income tax treatment of tertiary injectant costs was unclear. In enacting section 193, Congress sought to clarify the tax treatment and encourage the use of qualified tertiary injectants. See, e.g., Joint Committee on Taxation, *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980* (JCS-1-81), January 29, 1981, pp. 114-115.

[888] Treas. Reg. sec. 1.193-1.

[889] Sec. 193(c).

[890] Sec. 193(b). A tertiary recovery method is any of the nine methods described in section 212.78(c)(1) - (9) of the June 1979 energy regulations, as defined in former section 4996(b)(8)(C), or any other method approved by the IRS.

gas or crude oil) is not a qualified tertiary injectant expense unless the amount of the recoverable hydrocarbon injectant in the qualified tertiary injectant is insignificant.[891]

Expensing of mining exploration and development costs

A taxpayer generally must capitalize costs that benefit future periods, including certain direct and indirect costs of producing inventory or property used in the taxpayer's business.[892] Capitalized costs may be recovered through depreciation, depletion, cost of goods sold, or upon abandonment or other disposition. However, special rules apply with respect to mining exploration and development costs.[893]

Exploration costs

Taxpayers generally may elect to deduct amounts paid or incurred during the tax year in ascertaining the existence, location, extent, or quality of any deposit of ore, provided the amounts are paid or incurred prior to the beginning of the development stage of the mine.[894] The development stage of a mine typically begins when, based on all relevant facts and circumstances, deposits of ore or other minerals are demonstrated to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer.[895] Generally, if mining exploration costs are not expensed, but are capitalized, they may be recovered through depletion or deducted as a loss if the exploration does result in the acquisition of productive property. For a corporation that has elected to expense mining exploration costs, 30 percent of the exploration costs must be capitalized and amortized over a 60-month period.[896]

Expenditures for the acquisition or improvement of depreciable property may not be deducted under the election; however, depreciation is considered as an eligible expenditure. The election may not be made only with respect to any oil or gas deposit or any mineral deposit for which a deduction for percentage depletion is not permitted under section 613.[897] Expenditures paid or incurred with respect to mineral deposits located outside of the United States are not eligible for the election, but may, at the election of the taxpayer, be included in depletable basis

[891] Sec. 193(b)(2). Treas. Reg. sec. 1.193-1(c)(3) provides that an injectant contains more than an insignificant amount of recoverable hydrocarbons if the fair market value of the recoverable hydrocarbon component of the injectant, in the form in which it is recovered, equals or exceeds 25 percent of the cost of the injectant.

[892] Secs. 263 and 263A.

[893] Secs. 616 and 617.

[894] Sec. 617(a).

[895] Treas. Reg. sec. 1.617-1(a).

[896] Sec. 291(b)(1)(B).

[897] Sec. 617(a).

or, if no such election is made, deducted ratably over the 10-year period beginning with the taxable year in which the expenditures are paid or incurred.[898]

Expenditures expensed pursuant to the election are subject to recapture when the mine reaches the producing stage.[899] The recapture generally is accomplished through the disallowance of depletion with respect to the mining property that contains the mine until the expensed amounts are recaptured. A taxpayer may instead elect to include in gross income "adjusted exploration expenditures" for all mines reaching the producing stage during the taxable year.[900] Adjusted exploration expenditures are the amounts for which the taxpayer claimed a deduction under section 617 that would have been included in the basis of the property reduced by the excess of the percentage depletion over the depletion allowable under section 611 had the amounts been capitalized.[901]

Notwithstanding the fact that a taxpayer has made the election to deduct mining exploration costs, the taxpayer is allowed to capitalize and amortize such costs over a 10-year period beginning with the month the expenditure was paid or incurred.[902] This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its mining exploration costs and capitalize the rest under this provision. The election allows a taxpayer to reduce or eliminate the mining exploration adjustments or preferences under the alternative AMT.

The uniform capitalization rules under section 263A do not apply to mining exploration costs otherwise deductible under section 617.[903]

Development costs

In general, expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) are expensed if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed.[904] Development expenditures are amounts paid or incurred after deposits of ore or other minerals

[898] Sec. 617(h). For these purposes, the United States includes the 50 states and the District of Columbia, as well as the Continental Shelf Areas adjacent to U.S. territorial waters and over which the United States has exclusive rights regarding exploration and exploitation of natural resources. See S. Rep. No. 313, 99th Cong., 2d Sess. 282 (1986).

[899] Sec. 617(b).

[900] Sec. 617(b)(1).

[901] Sec. 617(f).

[902] Sec. 59(e)(1). See also section 56(a)(7), which provides that mining exploration and development costs generally are capitalized and amortized ratably over 10 years beginning in the year the costs are paid or incurred for AMT purposes.

[903] Sec. 263A(c)(3).

[904] Sec. 616(a).

are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer.[905]

A taxpayer may elect to treat mining development expenditures paid or incurred during the taxable year as deferred expenses and recognize such amounts ratably as the units of produced ore or minerals benefited by such expenditures are sold. Special rules apply in the case of expenditures paid or incurred during the development stage of the mine that limit the election to the excess of the expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from the mine.

Depreciable property may not be expensed or treated as a deferred expense under section 616, but depreciation may be considered a development expenditure.[906] Expenditures with respect to the development of a mine or other natural deposit (other than an oil, gas, or geothermal well) located outside of the United States are deducted ratably over the 10-taxable year period beginning with the year the expenditures are paid or incurred unless the taxpayer elects to include the expenditures in the depletable basis of the property.[907]

Rules similar to those discussed above with respect to exploration costs apply to limit the deduction for development expenditures for corporations. Thus, a corporation that expenses mining development costs must capitalize 30 percent of the costs and amortize the capitalized costs over a 60-month period.[908] Like mining exploration costs, mining development costs deductible under section 616 are not subject to the uniform capitalization rules under section 263A.[909] Additionally, the special 10-year election under section 59(e) is available for mining development costs to mitigate or eliminate the effect of the AMT preference or adjustment.[910]

<u>Amortization period for geological and geophysical costs (sec. 167(h))</u>

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.[911] G&G costs incurred

[905] Treas. Reg. sec. 1.616-1(a).

[906] Sec. 616(a).

[907] Sec. 616(d).

[908] Sec. 291(b)(1)(B).

[909] Sec. 263A(c)(3).

[910] Sec. 59(e)(1). See also section 56(a)(7), which provides that mining exploration and development costs generally are capitalized and amortized ratably over 10 years beginning in the year the costs are paid or incurred for AMT purposes

[911] Geological and geophysical costs include expenditures for geologists, seismic surveys, gravity meter surveys, and magnetic surveys.

by independent producers and smaller integrated oil companies in connection with oil and gas exploration in the United States may generally be amortized over two years.[912]

Major integrated oil companies are required to amortize all G&G costs over seven years for costs paid or incurred after December 19, 2007 (the date of enactment of the Energy Independence and Security Act of 2007 ("EISA").[913] A major integrated oil company, as defined in section 167(h)(5)(B), is an integrated oil company[914] which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more.

In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property, but instead must continue to be amortized over the remaining applicable amortization period.

Percentage depletion (secs. 613 and 613A)

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset is being expended to produce income.[915] Certain costs incurred prior to drilling an oil or gas property or extracting minerals are recovered through the depletion deduction. These include the cost of acquiring the lease or other interest in the property.

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital. Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in

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[912] This amortization rule applies to G&G costs incurred in taxable years beginning after August 8, 2005, the date of enactment of the Energy Policy Act of 2005, Pub. L. No. 109-58. Prior to the effective date, G&G costs associated with productive properties were generally deductible over the life of such properties, and G&G costs associated with abandoned properties were generally deductible in the year of abandonment.

[913] Pub. L. No. 110-140. Prior to the enactment of the Energy Independence and Security Act of 2007, major integrated oil companies were required to amortize G&G costs paid or incurred after May 17, 2006 over five years, as provided in Energy Tax Incentives Act of 2005.

[914] Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.

[915] In the context of mineral extraction, depreciable assets are generally used to recover depletable assets. For example, natural gas gathering lines, used to collect and deliver natural gas, have a class life of 14 years and a depreciation recovery period of seven years.

the mineral deposit, however, does not acquire an economic interest merely by possessing an economic or pecuniary advantage derived from production through a contractual relation.

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[916] Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, a percentage, varying from five percent to 22 percent, of the taxpayer's gross income from a producing property is allowed as a deduction in each taxable year.[917] The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[918] Such producers and royalty owners may generally claim percentage depletion at a rate of 15 percent.[919]

The amount deducted generally may not exceed 50 percent (100 percent in the case of oil and gas properties) of the taxable income from the property in any taxable year.[920] Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year (determined before such deduction and adjusted for certain loss carrybacks and trust distributions).[921] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.[922]

A taxpayer is required to determine the depletion deduction for each property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost

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[916] Secs. 611 - 613.

[917] Sec. 613.

[918] Sec. 613A(c).

[919] Sec. 613A(c)(1).

[920] Sec. 613(a). For marginal production, discussed *infra*, this limitation is suspended for taxable years beginning after December 31, 1997, and before January 1, 2008 and for taxable years beginning after December 31, 2008 and before January 1, 2010.

[921] Sec. 613A(d)(1).

[922] In the case of iron ore and coal (including lignite), a corporate preference reduces the amount of percentage depletion calculated by 20 percent of the amount of percentage depletion in excess of the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year). Sec. 291(a)(2).

depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question.[923]

Limitation on oil and gas percentage depletion to independent producers and royalty owners

As stated above, percentage depletion of oil and gas properties generally is not permitted, except for independent producers and royalty owners, certain fixed-price gas contracts, and natural gas from geopressured brine. For purposes of the percentage depletion allowance, an independent producer is any producer that is not a "retailer" or "refiner." A retailer is any person that directly, or through a related person, sells oil or natural gas (or a derivative thereof): (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person that is obligated to market or distribute such oil or natural gas (or a derivative thereof) under the name of the taxpayer or the related person, or that has the authority to occupy any retail outlet owned by the taxpayer or a related person.[924]

Bulk sales of crude oil and natural gas to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are not treated as retail sales. Further, if the combined gross receipts of the taxpayer and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year, the taxpayer will not be treated as a retailer.

A refiner is any person that directly or through a related person engages in the refining of crude oil in excess of an average daily refinery run of 75,000 barrels during the taxable year.[925]

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.[926] For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated;[927] each group is then treated as one producer in applying the 1,000-barrel limitation.

In addition to independent producers and royalty owners, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

[923] Sec. 613(a).

[924] Sec. 613A(d)(2).

[925] Sec. 613A(d)(4).

[926] Sec. 613A(c).

[927] Sec. 613A(c)(8).

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), if an interest in a proven oil or gas property was transferred (subject to certain exceptions), the production from such interest did not qualify for percentage depletion.[928] The 1990 Act repealed the limitation on claiming percentage depletion on transferred properties effective for property transfers occurring after October 11, 1990.

Percentage depletion on marginal production

The 1990 Act also created a special percentage depletion provision for oil and gas production from so-called marginal properties held by independent producers or royalty owners.[929] Under this provision, the statutory percentage depletion rate is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than $20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year. The increased rate applies for the taxpayer's taxable year that immediately follows a calendar year for which the average crude oil price falls below the $20 floor. To illustrate the application of this provision, the average price of a barrel of crude oil for calendar year 1999 was $15.56. Thus, the percentage depletion rate for production from marginal wells was increased to 19 percent for taxable years beginning in 2000. Since the price of oil currently is above the $20 floor, there is no increase in the statutory depletion rate for marginal production.

The Code defines the term "marginal production" for this purpose as domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (i.e., oil that has a weighted average gravity of 20 degrees API or less, corrected to 60 degrees Fahrenheit).[930] A stripper well property is any oil or gas property that produces a daily average of 15 or fewer equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.[931]

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year. The fact that a property is or is not a stripper well property for one year does not affect the determination of the status of that property for a subsequent year. Further, a taxpayer makes the stripper well property determination for each separate property interest (as defined under section 614) held by the taxpayer during a calendar year. The determination is based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. A property qualifies as a stripper well

[928] Pub. L. No. 101-508.

[929] Sec. 613A(c)(6).

[930] Sec. 613A(c)(6)(D).

[931] Sec. 613A(c)(6)(E).

property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.

If a taxpayer's property consists of a partial interest in one or more oil- or gas-producing wells, the determination of whether the property is a stripper well property or a heavy oil property is made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's interest. If the property satisfies the requirements of a stripper well property, then the benefits of this provision apply with respect to the taxpayer's allocable share of the production from the property. The deduction is allowed for the taxable year that begins during the calendar year in which the property so qualifies.

The allowance for percentage depletion on production from marginal oil and gas properties is subject to the 1,000-barrel-per-day limitation discussed above. Unless a taxpayer elects otherwise, marginal production is given priority over other production for purposes of utilization of that limitation.

Percentage depletion for hard mineral fossil fuel properties

Percentage depletion is available for taxpayers with an economic interest in a coal mine or other hard mineral fossil fuel property such as lignite or oil shale properties. The depletion rate for coal and lignite is 10 percent.[932] For oil shale, the rate generally is 15 percent, but the rate drops to 7.5 percent for shale used or sold for use in the manufacture of sewer pipe or brick or as sintered or burned lightweight aggregates.[933]

As noted above, the percentage depletion deduction is limited to 50 percent of the taxable income from the property (determined before depletion and the deduction under section 199). Additionally, a corporation's percentage depletion deduction with respect to coal or lignite properties is reduced by 20 percent of the excess of the percentage depletion deduction over the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year).[934]

The excess of percentage depletion over cost depletion is a tax preference in computing a taxpayer's alternative minimum taxable income ("AMTI").[935]

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[932] Sec. 613(b)(4).

[933] Secs. 613(b)(2)(B) and (5).

[934] Sec. 291(a)(2).

[935] Sec. 57(a)(1).

Deduction for income attributable to domestic production of oil and gas, coal, and other hard mineral fossil fuels

Section 199 of the Code provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the lesser of a taxpayer's taxable income or its qualified production activities income.[936] For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction was three percent and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent. With respect to a taxpayer that has oil related qualified production activities income for taxable years beginning after 2009, the deduction is limited to six percent of the least of its oil related production activities income, its qualified production activities income, or its taxable income.[937]

A taxpayer's deduction under section 199 for a taxable year may not exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.[938]

Qualified production activities income

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

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[936] In the case of an individual, the deduction is equal to a portion of the lesser of the taxpayer's adjusted gross income or its qualified production activities income. For this purpose, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, and without regard to the section 199 deduction.

[937] "Oil related qualified production activities income" means the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas or any primary product thereof (as defined in section 927(a)(2)(C) prior to its repeal). Treas. Reg. sec. 1.927(a)-1T(g)(2)(i) defines the term "primary product from oil" to mean crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. Additionally, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil. Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii) defines the term "primary product from gas" as all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii) provides that these primary products and processes are not intended to represent either the only primary products from oil or gas or the only processes from which primary products may be derived under existing and future technologies. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv) provides as examples of non-primary oil and gas products petrochemicals, medicinal products, insecticides, and alcohols.

[938] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property ("QPP") that was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States;[939] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;[940] or (5) engineering or architectural services performed in the United States with respect to the construction of real property in the United States.

Drilling oil or gas wells

The Treasury regulations provide that qualifying construction activities performed in the United States include activities relating to drilling an oil or gas well.[941] Under the regulations, activities the cost of which are intangible drilling and development costs within the meaning of Treas. Reg. sec. 1.612-4 are considered to be activities constituting construction for purposes of determining domestic production gross receipts.[942]

Qualifying in-kind partnerships

In general, an owner of a pass-through entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. However, the Treasury regulations provide a special rule for "qualifying in-kind partnerships," which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.[943] In the case of a qualifying in-kind partnership, each partner is treated as having MPGE the property MPGE by the partnership that is distributed to that partner.[944] If a partner of a qualifying in-kind

[939] Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

[940] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting, that is not performed in connection with activities that otherwise constitute substantial renovation.

[941] Treas. Reg. sec. 1.199-3(m)(1)(i).

[942] Treas. Reg. sec. 1.199-3(m)(2)(iii).

[943] Treas. Reg. sec. 1.199-9(i)(2).

[944] Treas. Reg. sec. 1.199-9(i)(1).

partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE activities previously conducted by the qualifying in-kind partnership with respect to that property.[945]

Alternative minimum tax

The deduction for domestic production activities is allowed for purposes of computing AMTI (including adjusted current earnings). The deduction in computing AMTI is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the AMTI (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

Exception from passive loss rules for working interests in oil and gas property (sec. 469)

The passive loss rules limit deductions and credits from passive trade or business activities.[946] A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial.[947] 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.

Losses from certain working interests in oil and gas property are not limited under the passive loss rule.[948] Thus, losses and credits from such interests can be used to offset other income of the taxpayer without limitation under the passive loss rule. Specifically, a passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity. If the taxpayer has a loss from a working interest in any oil or gas property that is treated as not from a passive activity, then net income from the property for any succeeding taxable year is treated as income of the taxpayer that is not from a passive activity.

[945] *Ibid*.

[946] Sec. 469. These rules were enacted in 1986 to curtail tax shelters. They apply to individuals, estates and trusts, and closely held corporations.

[947] Regulations provide more detailed standards for material participation. See Treas. Reg. secs. 1.469-5 and -5T.

[948] Sec. 469(c)(3). See also Treas. Reg. sec. 1.469-1T(e)(4).

In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property. Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio income.

When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision. Thus, for purposes of the passive loss rules, an interest owned by a limited partnership is not treated as a working interest with regard to any limited partner, and an interest owned by an S corporation is not treated as a working interest with regard to any shareholder. The same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form.

When an interest is not treated as a working interest because the taxpayer's form of ownership limits his liability, the general rules regarding material participation apply to determine whether the interest is treated as a passive activity. Thus, for example, a limited partner's interest generally is treated as a passive activity. In the case of a shareholder in an S corporation, the general facts and circumstances test for material participation applies and the working interest exception does not apply, because the form of ownership limits the taxpayer's liability.

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity. In such a case, any net income realized by the taxpayer from the property (or from any substituted basis property, e.g., property acquired in a section 1031 like-kind exchange for such property) in a subsequent year also is treated as active. Under this rule, for example, if a taxpayer claims losses for a year with regard to a working interest and then, after the property to which the interest relates begins to generate net income, transfers the interest to an S corporation in which he is a shareholder, or to a partnership in which he has an interest as a limited partner, his interest with regard to the property continues to be treated as not passive.

Capital gains treatment of certain coal royalties

Royalties generally are taxed as ordinary income for Federal income tax purposes. However, the Code provides a special rule that treats royalties from certain dispositions of coal as capital gains. Specifically, in the case of the disposal of coal (including lignite) mined in the United States, held for more than one year prior to disposal, by the owner in a form under which the owner retains an economic interest in such coal, the excess of the amount realized from the sale over the adjusted depletable basis of the coal plus certain disallowed deductions is treated as the sale of depreciable property used in the owner's trade or business (i.e., the sale of section 1231 property).[949] For these purposes, an owner means any person who owns an economic

[949] Secs. 631(c) and 1231(b)(2).

interest in coal in place, including a lessee or sublessor thereof.[950] Section 631(c) does not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal.[951]

Section 1231 generally provides that if recognized gains on the sale or exchange of property used in a taxpayer's trade or business,[952] plus certain gains on involuntary conversions, exceed losses from such sales, exchanges, or conversions, the gain is long-term capital gain.[953] If losses exceed gains, the losses are treated as ordinary losses. The net ordinary losses are subject to certain recapture provisions. Thus, if the owner's section 1231 gains, including royalties from coal disposals described in section 631(c), exceed its section 1231 losses, the royalties will be treated as long-term capital gains.

Section 631(c) is not elective. Thus, if a taxpayer meets the requirements of the section, royalties from the disposal of coal will be treated as the disposition of section 1231 property. An owner may not claim percentage depletion with respect to coal that is subject to section 631(c) if for the taxable year of the sale the maximum tax rate for capital gains or losses is less than the maximum tax rate for ordinary income.[954]

Description of Proposal

The proposal repeals (1) the enhanced oil recovery credit, (2) the marginal wells credit, (3) the expensing of IDCs, (4) the deduction for tertiary injectants,[955] (5) the exception for passive losses from working interests in oil and gas properties, (6) percentage depletion for oil and gas, coal (including lignite), and certain oil shale, (7) expensing and 60-month amortization of mining exploration and development costs for coal (including lignite) and certain oil shale, (8) the domestic manufacturing deduction for income derived from the domestic production of oil,

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[950] Sec. 631(c).

[951] *Ibid*.

[952] Property used in the trade or business generally means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than one year, and real property used in the trade or business, held for more than one year. Section 1231 property does not include inventory or property held for sale to customers in the ordinary course of the taxpayer's business. However, section 1231 property includes coal to which section 631 applies, even if such coal is held as inventory or for sale to the taxpayer's customers in the ordinary course of the taxpayer's business.

[953] Special recapture rules apply for non-recaptured section 1231 losses. See section 1231(d).

[954] Under section 631(c) royalty income is reduced by the adjusted depletion basis of the coal disposed of plus administrative costs disallowed under section 272. The adjusted depletion basis is the same amount as would have been the cost depletion allowance under section 612.

[955] If section 193 were repealed, the treatment of tertiary injectant expenses would revert to prior law and might include capitalization and recovery through depreciation, capitalization and recovery as consumed (e.g., as a supply), or deduction as loss in the year of abandonment or the year production benefits ceased. Amounts expensed as depreciation, depletion, or supplies may be subject to capitalization under section 263A. See, e.g., Treas. Reg. sec. 1.263A-1(e)(3).

gas, coal (including lignite), and certain oil shale, or primary products thereof, and (9) capital gains treatment for certain coal (including lignite) royalties. With respect to IDCs and mining exploration and development costs, the proposal requires that such costs be capitalized and recovered through depletion or depreciation, as applicable.

The proposal also increases the amortization period for G&G costs of independent producers from two to seven years. The seven-year amortization period would apply even if the property is abandoned such that any remaining unrecovered basis of the abandoned property would continue to be recovered over the remainder of the seven-year period.

Effective date.−The repeal of the enhanced oil recovery credit, the marginal wells credit, the exception for passive losses from working interests in oil and gas properties, percentage depletion for oil, gas, coal, and other hard mineral fossil fuels, and the domestic manufacturing deduction for the production of oil, gas, coal, or other hard mineral fossil fuels are effective for taxable years beginning after December 31, 2010. The capitalization of IDCs, the repeal of the deduction for tertiary injectant costs, the increased amortization period for G&G expenses, and the repeal of expensing and 60-month amortization for mining exploration and development costs for coal and other hard mineral fossil fuels are effective for amounts paid or incurred after December 31, 2010. The repeal of capital gains treatment for certain coal royalties is effective for amounts realized in taxable years beginning after December 31, 2010.

Analysis

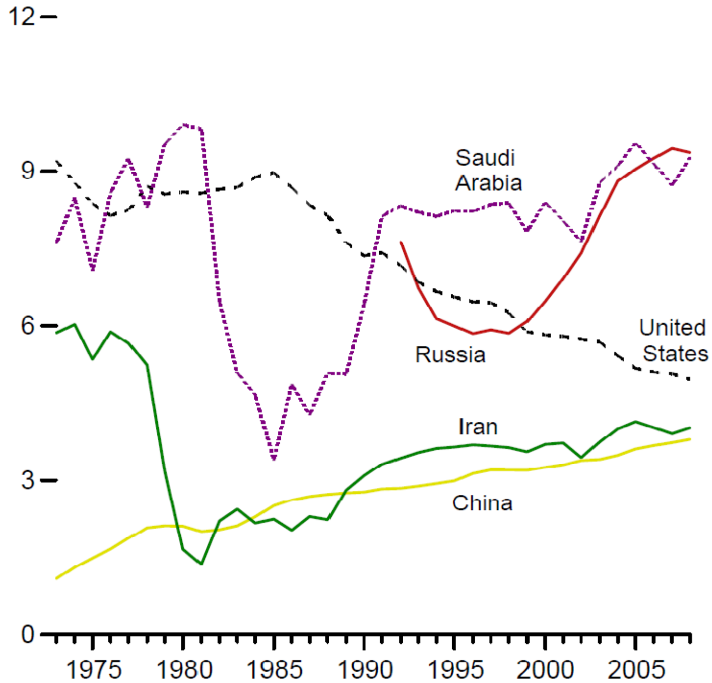
Overview of domestic oil, natural gas, and coal production

Oil and natural gas production

Despite having less than two percent of the world's oil reserves,[956] the United States remains one of the largest oil producers in the world.

[956] Energy Information Administration, *International Energy Outlook* 2009, May 27, 2009, Table 4.

Figure 2.−Crude Oil Production in Selected Countries (millions of barrels per day)



Source: Energy Information Administration, Monthly Energy Review, May 2009, Table 11.1a.

Although domestic oil production has declined steadily since the mid-1980s, domestic oil production is predicted to increase over the next 20 years, with most of the near-term increase resulting from deepwater offshore drilling.[957] Domestic onshore crude oil production is also projected to increase, primarily as the result of increased application of carbon dioxide-enhanced oil recovery techniques and the startup of liquids production from oil shale.[958]

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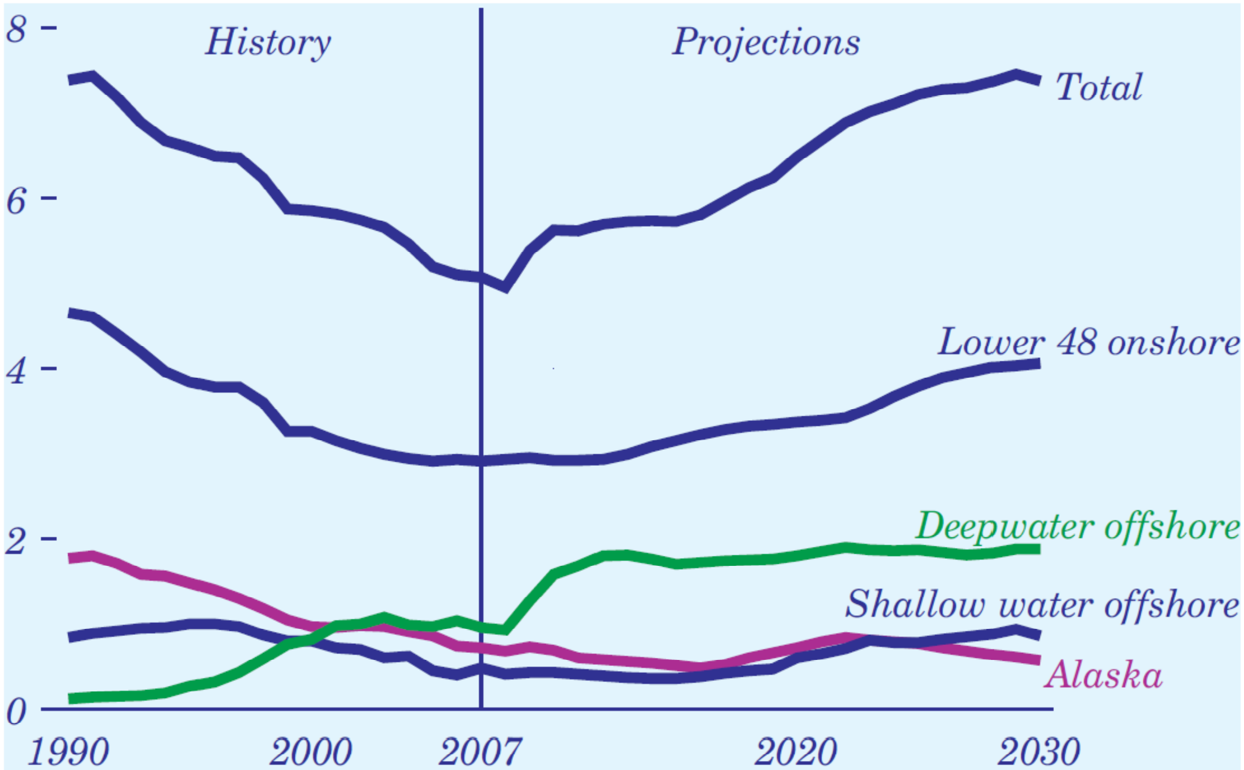
[957] Energy Information Administration, *Annual Energy Outlook 2009*, March 2009, p. 79.

[958] *Ibid.*

Figure 3.−Projected Domestic Crude Oil Production by Source, 1990-2030
(millions of barrels per day)



Source: Energy Information Administration, Annual Energy Outlook 2009, March 2009, Figure 70, p. 79.

Because the remaining domestic oil reserves generally require more costly secondary or tertiary recovery techniques, domestic crude oil production is highly sensitive to world crude oil prices.[959]

The United States has a slightly larger share of the world's natural gas reserves compared to oil reserves but it still amounts to less than four percent of the global total.[960] Like oil, however, domestic production of natural gas is expected to increase, with most of the increase attributable to onshore unconventional production (such as natural gas produced from tight sand and shale formations).[961]

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[959] *Ibid.*

[960] Energy Information Administration, *International Energy Outlook* 2009, May 27, 2009, Table 6.

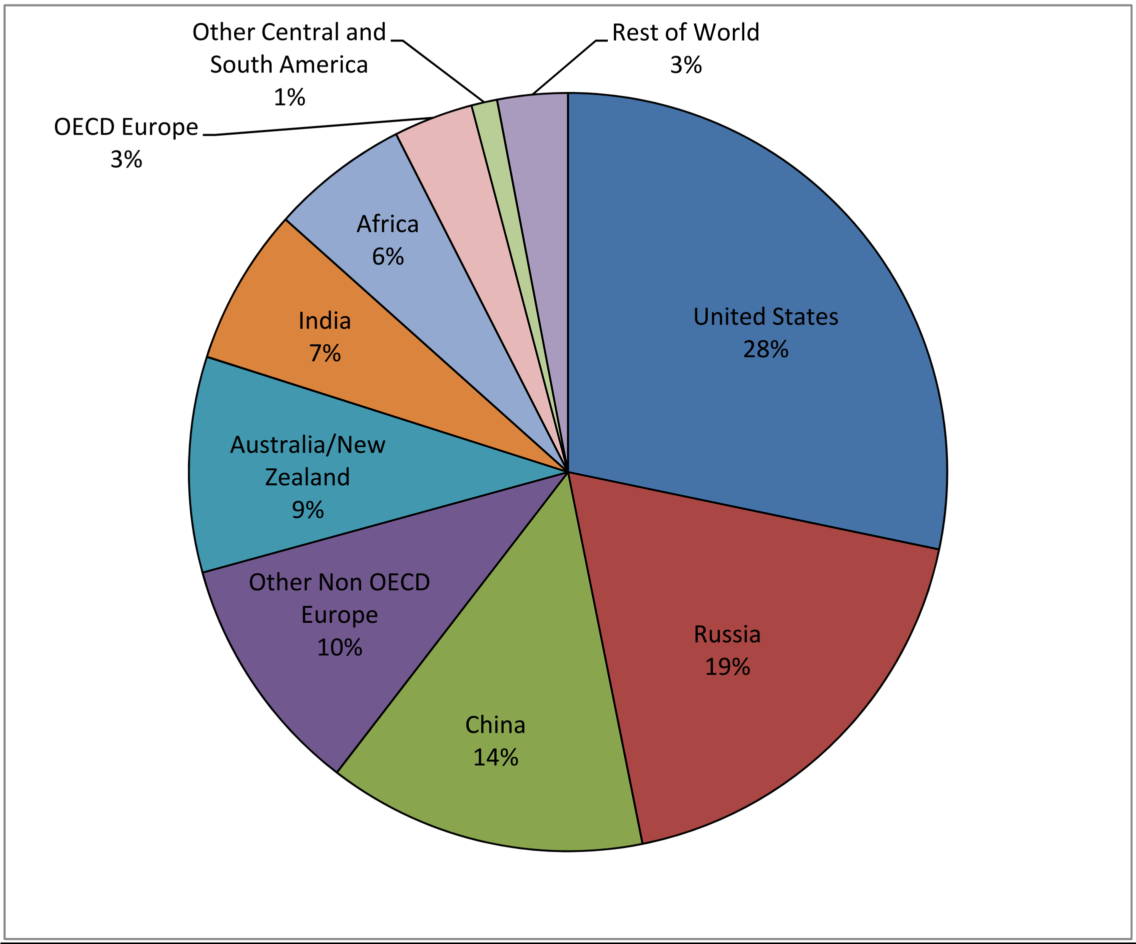
[961] Energy Information Administration, *Annual Energy Outlook 2009*, March 2009, pp. 4, 77.

The oil and gas industry continues to be a large employer in the United States. For 2009, the domestic oil and gas extraction sector employed a seasonally adjusted average of 166,600 workers.[962]

Coal production

As with oil, the United States is one of the biggest producers of coal in the world.[963] Unlike with oil, however, and as illustrated below, the United States has by a substantial margin the world's largest coal reserves.

Figure 4.−Estimated World Coal Reserves by Country



Source: Generated using data from the Energy Information Administration, *International Energy Outlook* 2009, May 27, 2009, Table 9.

[962] Bureau of Labor Statistics, *Monthly Labor Review*, vol. 133, no. 2, February 2010, Table 12, p. 63.

[963] The United States is the world's second largest producer of coal after China. Energy Information Administration, *International Energy Outlook* 2009, May 27, 2009, Table 7.

Domestic coal production is projected to grow slowly over the next 20 years.[964]

The coal mining sector continues to be a major source of jobs in the United States. For 2009, the coal mining sector employed a seasonally adjusted average of 80,200 workers.[965]

History of specific oil and gas provisions

The tax rules governing oil and gas production have undergone numerous changes over the past half century. The following table lists the major changes to the provisions whose repeal has been proposed.

Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities

Year	Act	Code Section	Description of Modification
1969	Tax Reform Act of 1969 (Pub. L. No. 91-172)	613(b)	Percentage depletion rates for oil and gas wells decreased from 27.5 percent to 15 percent.
1975	Tax Reduction Act of 1975 (Pub. L. No. 94-12)	613A	Percentage depletion eliminated for integrated oil and gas companies; taxable income limitation to independent producers and royalty owners claiming percentage depletion added to the Code.
1980	Crude Oil Windfall Profit Tax Act of 1980 (Pub. L. No. 96-223)	193	Deduction for qualified tertiary injectant expenses added to the Code.
1982	Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248)	291(b)	Provision requiring amortization over 36 months of 15 percent of intangible drilling costs (IDCs) not currently deductible by integrated oil and gas companies added to the Code.
1984	Deficit Reduction Act of 1984 (Pub. L. No. 98-369)	291(b)	IDC capitalization percentage increased from 15 percent to 20 percent.
1986	Tax Reform Act of 1986 (Pub. L. No. 99-514)	291(b)	IDC capitalization percentage increased to 30 percent and extended the amortization period to 60 months
		469(c)(3)	Provision excluding working interests in oil and gas property from the definition of a passive activity for purposes of the limitation on passive activity losses added to the Code.

[964] Energy Information Administration, *Annual Energy Outlook 2009*, March 2009, p. 83.

[965] Bureau of Labor Statistics, *Monthly Labor Review*, vol. 133, no. 2, February 2010, Table 12, p. 63.

Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities			
Year	Act	Code Section	Description of Modification
1990	Omnibus Budget Reconciliation Act of 1990 (Pub. L. No. 101-508)	43	Enhanced oil recovery credit added to the Code.
		613	Maximum percentage depletion allowance for oil and gas properties increased from 50 percent to 100 percent of income from the property.
1997	Taxpayer Relief Act of 1997 (Pub. L. No. 105-34)	613A	Temporary suspension of taxable income limit for marginal production.[966]
2004	American Jobs Creation Act of 2004 (Pub. L. No. 108-357)	45I	Marginal wells credit added to the Code.
		199	Deduction for domestic production activities (including domestic oil and gas production) added to the Code.
2005	Energy Policy Act of 2005 (Pub. L. No. 109-58)	167(h)	Two-year amortization of geological and geophysical (G&G) costs added to the Code. Prior to this, G&G costs incurred with respect to abandoned sites could be expensed, while G&G costs associated with producing wells had to be recovered over the life of the well.
2006	Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222)	167(h)	Two-year amortization period of G&G costs extended to five years for major integrated oil companies.
2007	Energy Independence and Security Act of 2007 (Pub. L. No. 110-140)	167(h)	Five-year amortization period of G&G costs extended to seven years for major integrated oil companies.
2008	Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343)	199	Capped the section 199 deduction percentage for oil related qualified production activities to six percent for taxable years beginning after 2009.

As the table makes apparent, Congressional action with respect to domestic oil and gas production incentives has varied over time. With some exceptions, during the 1970s and 1980s, the trend of Congressional action was to reduce or limit the tax benefits available to oil and gas producers. During the 1990s and the early part of this decade, the trend reversed direction and favored expanded incentives. More recently, Congress has begun reducing incentives once

[966] This temporary suspension has been extended multiple times, most recently in the Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) through December 31, 2009.

again. In the broadest sense, these trends tend to coincide with periods of high and low oil prices.

History of specific coal provisions

Chronology of Major Post-1954 Tax Law Changes Affecting Coal Production Activities			
Year	Act	Code Section	Description of Modification
1964	Revenue Act of 1964 (Pub. L. No. 88-272)	631(c)	Capital gains treatment for certain coal royalties added to the Code.
1982	Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248)	291(b)	Provision requiring designated percentage (15-21 percent) of mining exploration and development costs to be capitalized and recovered ratably over five year taxable years added to the Code.
1986	Tax Reform Act of 1986 (Pub. L. No. 99-514)	291(b)	Mining exploration and development cost capitalization percentage increased to 30 percent and amortization period of 60 months.
		616(d)	Foreign development costs required to be capitalized and either depleted, or amortized over 10 years.
		617(h)	Foreign exploration costs required to be capitalized and either depleted, or amortized over 10 years.
2004	American Jobs Creation Act of 2004 (Pub. L. No. 108-357)	199	Deduction for domestic production activities (including domestic coal production) added to the Code.

As is evident in the table, there has been relatively little Congressional action with respect to domestic coal production incentives. The most recent legislation changes have been to limit coal preferences to domestic production.

Effect of repealing fossil fuel production incentives

A common rationale for favorable tax treatment of certain activities (tax credits or other forms of subsidy), or unfavorable treatment (taxes), is that there exist externalities in the consumption or production of certain goods. An externality exists when, in the consumption or production of a good, there is a difference between the cost or benefit to an individual and the cost or benefit to society as a whole. When the social costs of consumption or production exceed the private costs of consumption or production, a negative externality exists. For example, the private cost of driving a badly-out-of-tune car is just the extra gasoline or oil required, but the social cost also includes all of the extra pollution that it creates. When the social benefits from consumption or production exceed private benefits, a positive externality exists. When negative externalities exist, there will be over-consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under-consumption and under-production of the good producing the positive externality. The reason for the over-consumption or under-consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face. But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the private actions lead to the socially optimal level of consumption and production, because in this case private costs and benefits will be equal to social costs and benefits.

As mentioned above, pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, one intervention that could produce a more socially desirable level of pollution would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. In the case of a positive externality, an appropriate economic policy would be to impose a negative tax (i.e. a credit) on the consumption or production that produces the positive externality. By the same logic as above, the externality becomes internalized, and the private benefits from consumption become equal to the social benefits, leading to the socially optimal level of consumption or production. The favorable tax treatment accorded fossil fuel industries represents other, less direct, means of subsidizing an activity through the tax code by reducing the tax burden on capital employed in the sector, thus encouraging more capital to be employed in that sector of the economy.

Many observers today would agree that there are negative externalities to the consumption of fossil fuels, including both pollution and increased dependence on foreign sources of oil. For this reason, many feel that fossil fuels should be taxed more heavily rather than granted certain favorable treatment in the Code. Repealing incentives for fossil fuel production would increase the after-tax costs associated with these activities, likely reduce the amount of capital employed in these activities in the long run, and potentially increase the prices of fossil fuels.[967] If fossil fuel prices were to rise as the result of the repeal of incentives for fossil fuel production, there could be substitution from fossil fuels and into other energy sources, including nuclear or renewable sources of energy. The impact on pollution of any such substitution is unclear and would depend on the type and quantity of pollution associated with the alternative energy resource. To the extent that addressing pollution concerns was a major

[967] Any price rise is likely to be attenuated in the case of a globally traded commodity, such as oil, where the price is determined globally. In such a case, a decrease in the United States' output may have a greater effect increasing imports of foreign oil than on increasing crude prices for domestic consumers. Similarly, an increase in the United States' output may have a greater effect displacing imports of foreign oil than on decreasing crude prices for domestic consumers.

objective, economic theory would suggest the need for a tax on the externality from the consumption of fossil fuels that equaled the social cost from the consumption. Simply removing selected subsidies related to the production of fossil fuels does not address the issue of establishing proper prices on the consumption of goods that cause pollution.

If the proposals caused substitution into alternative sources of energy, reliance on foreign sources of fossil fuels could be reduced because nuclear and renewable energy sources are domestically produced.[968] Alternatively, to the extent that the proposals primarily affect domestic production of fossil fuels, it is possible that any substitution into these alternate energy sources reflects a substitution from domestic production of fossil fuels into domestic production of these alternate sources, thus leaving the United States' reliance on foreign fossil fuels unchanged. Furthermore, as the proposals are likely to have no effect on the world price of fossil fuels, any increase in prices for domestically consumed fossil fuels is likely to be attenuated, and the proposals could primarily result in substitution of foreign fossil fuel sources for domestic sources whose production is more reliant on the subsidies provided in current law. Such an outcome would further imply that the proposals would not lead to any shift into the alternate energy sources of nuclear or renewables. Lastly, other observers have argued that current prices and expected future demand for fossil fuels provide sufficient market-based incentives for domestic exploration and production, and have argued that the present law subsidies are unnecessary to secure a viable domestic fossil fuels production industry.

Additional motivations may also support specific proposed changes. For example, with respect to tertiary injectants, opponents of repeal have also argued that the deduction for tertiary injectants encourages the use of carbon dioxide in enhanced oil recovery projects. Such projects represent a primary method of carbon sequestration, which reduces greenhouse gas emissions by capturing and storing carbon dioxide that would otherwise be released into the atmosphere.[969] Proponents of the proposal might argue that encouraging carbon dioxide sequestration is better handled through incentives directly targeting carbon sequestration.

Another example is the exception to the passive loss rules for working interests in oil and gas properties, which in addition to providing an incentive to produce oil and gas, creates the potential to shelter income that would otherwise be taxable. It could be argued that tax sheltering has become an increasing problem in the Federal tax system as some of the base-broadening and rate-lowering changes made by the Tax Reform Act of 1986 have been reversed or modified by subsequent legislation. From a tax policy perspective (rather than an energy policy perspective), some might argue that the perception of fairness in the tax system, as well as the need for improved horizontal equity among individual taxpayers, support repeal of the special tax benefits for oil and gas working interests.

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[968] Much imported crude oil is used in the transportation sector, and little is used in electricity generation. The scope for renewables to displace fossil fuels is thus limited by the ability to produce and use transportation grade renewable fuels, or to displace fuel-based transportation with battery powered transportation.

[969] See also sec. 45Q, which provides a credit for certain qualified tertiary injectant projects that use carbon sequestration.

Those in favor of retaining incentives for domestic production might argue that a healthy domestic fossil fuels production base serves national security goals, by reducing our dependence on foreign sources of oil. However, it can be argued that such reliance is more effectively addressed through a direct tax on imported oil or an import fee, which could encourage less consumption and promote the use of lower emission, renewable energy alternatives. Others might argue that in the current economic environment, eliminating the incentives might adversely affect employment in domestic fossil fuel production. Furthermore, the deduction for domestic production activities is a broadly available incentive for all domestic production industries, and thus does not bias investment in favor of the fossil fuels sector. Repealing the deduction for the fossil fuels sector alone would bias investment away from this sector.

Finally, it could be argued that some of the President's fossil fuels proposals might reintroduce administrative complexity currently absent under present law, such as in the case of the repeal of the deduction for tertiary injectants.

Prior Action

The proposal with respect to G&G expenses was included in the President's budget for fiscal year 2009. Similar G&G proposals were also included in the President's budget proposals for fiscal years 2007 and 2008. The President's budget proposal for fiscal year 2007 included a proposal to extend the G&G amortization period to five years for all producers. At the time, all domestic oil and gas producers (including major integrated oil companies) could amortize their G&G expenses over two years. Congress partially implemented the 2007 proposal by extending the G&G amortization period to five years for major integrated oil companies. The President's budget proposal for fiscal year 2008 included a proposal to extend the G&G amortization period to five years for independent producers. At the time, independent producers could amortize their G&G expenses over two years while major integrated oil companies had to amortize their G&G expenses over five years. Congress did not implement the 2008 proposal but extended the amortization period to seven years for major integrated oil companies.

J. Treat Income of Partners for Performing Services as Ordinary Income

Present Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxable upon the receipt of the partnership interest.[970]

In 1993, the Internal Revenue Service, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profit interest for services as not a taxable event for the partnership or the partner.[971] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[972] clarifies that this treatment applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[973]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.[974] A partnership capital interest for this purpose is an interest that

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[970] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T. C. 530 (1971), *aff'd* 492 F.2d 286 (7th Cir. 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner,* 943 F. 2d 815 (8th Cir. 1991)).

[971] Rev. Proc. 93-27 (1993-2 C.B. 343) citing the *Diamond* and *Campbell* cases, *supra*.

[972] Rev. Proc. 2001-43 (2001-2 C.B. 191). This result applies under the guidance even if the interest is substantially nonvested on the date of grant.

[973] A similar result would occur under the "safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

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

would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[975]

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[976] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[977] The proposed regulations

[975] Rev. Proc. 93-27, 1993-2 C.B. 343.

[976] Sec. 83(h).

[977] 70 Fed. Reg. 29675 (May 24, 2005).

provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also contain a rule that permits a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant) in a partnership, under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[978] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

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

Employment tax treatment of partners

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[979] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[980]

[978] Sec. 702.

[979] See Chapter 21 of the Code.

[980] Sec. 1401.

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[981] The amount of wages subject to this component is capped at $106,800 for 2010. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[982]

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $106,800 for 2010. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.[983] Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as capital gains and dividends, as described above). This rule applies to individuals who are general partners.

A special rule applies for limited partners of a partnership.[984] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive

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[981] Secs. 3101 and 3111.

[982] S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or are properly characterized as another type of income (typically, dividends) and therefore not subject to FICA tax.

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

[984] Sec. 1402(a)(13).

share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

For taxable years beginning after 2012, in the case of an individual, estate, or trust, an unearned income Medicare contribution tax is imposed.[985] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income[986] over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Description of Proposal

The proposal generally treats net income from any partnership interest as ordinary income if the partner provides personal services, except to the extent income is attributable to the partner's invested capital. Thus, the proposal recharacterizes the service partner's distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income in the hands of the partner. Such income is taxed at ordinary income tax rates and is subject to self-employment tax under the proposal. The proposal also recharacterizes as ordinary the gain from sale or exchange of such a partnership interest, except to the extent gain is attributable to the partner's invested capital. The proposal defines invested capital as money or other property that the partner contributes to the partnership, not including the proceeds of any loan or advance made by any other partner or by the partnership.

To prevent circumvention of the general rule through use of separate entities, the proposal provides that a person who performs services for an entity and holds a disqualified interest in the entity is subject to ordinary income treatment for income and gain with respect to the entity. A disqualified interest includes convertible or contingent debt, an option, or a derivative instrument with respect to the entity. The proposal is not intended to affect the qualification of a real estate investment trust holding a carried interest in a real estate partnership.

Effective date.−The proposal generally is effective for taxable years beginning after December 31, 2010.

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[985] Sec. 1411.

[986] Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1), net of the deductions and exclusions disallowed with respect to foreign earned income.

Analysis

In general

In addressing the merits of treating all service partnership interests as giving rise to ordinary income, several issues arise. A fundamental set of issues has to do with the conceptual rightness, or not, of treating partnership income of service providers as ordinary income in the nature of compensation for services. Arguments can be made about whether partnership income should lose its underlying character and be treated as ordinary income (and be subject to employment tax) because the recipient partner contributes labor to the partnership. Another set of issues has to do with the potential complexity, administrability, and appropriate scope of a proposal that applies broadly to all types and sizes of partnerships, raising related concerns about the level of tax sophistication of partners that perform services as well as the costs both to taxpayers and the government of complying with, and enforcing, the rules. A related but larger issue is that these income tax concerns would be eliminated by equalization of the tax rates on labor and capital income.

An interest of a service provider in a business is sometimes referred to as a carried interest, particularly as used in specialized businesses such as oil and gas exploration and investment fund management. A carried interest generally is a right to receive a percentage of profits without an obligation to contribute capital to the activity. In the case of a partnership, the carried interest may be structured as a partnership profits interest, under which the partner has a right to receive a percentage of partnership profits, but has no obligation to contribute capital to the partnership, and has no right to partnership assets on liquidation of the partnership.[987] A partner with only a profits interest generally does not have an obligation to contribute to the partnership's capital if the partnership experiences losses.

Fundamental tax policy issues relating to carried interests

In general

Historically, labor income of individuals has generally been taxed at ordinary rates, while some forms of capital income[988] have generally been taxed at lower rates.[989] In addition, labor

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[987] As income is earned by the partnership but is not yet distributed to the partner with the profits interest, the partner's share of these earnings is credited to his capital account. However, the capital account is reduced when the earnings are distributed to the partner. Thus, the partner does not have rights in liquidation of the partnership once his profit share is distributed to him. Alternatively, in the investment fund management business, for example, the assets invested in the fund generally are managed by a group of individuals who contribute a relatively small amount of capital to the fund (in relation to amounts of capital contributed by the investors) and who provide investment expertise in selecting, managing, and disposing of fund assets.

[988] In general, capital income taxed at lower rates has historically included capital gain. Qualifying dividend income of individuals has been taxed at the same maximum rate as capital gain since 2003. This treatment is scheduled to expire at the end of 2010, as are the current maximum rates for both ordinary income and capital gain. However, during the 1970's, income from services was taxed at a maximum rate of 50 percent while investment income, including dividends, but not including capital gain, was taxed at a higher maximum rate of 70 percent. As an exception to the generalization that capital gains have historically been taxed at a rate lower than

income generally is subject to employment tax (generally 2.9 percent for amounts over $106,800, in 2010). In 2010, for individuals generally, the top rate of tax on capital gain is 15 percent, while the top rate on ordinary income is 35 percent. When the employment tax is added, the top rate on ordinary compensation income in excess of $106,800 is 37.9 percent for 2010. This rate differential is thought to be a motivating factor in taxpayers' choice to structure income as a carried interest that can give rise to capital gain rather than as fees or other ordinary compensation income. Carried interests may also be structured to achieve deferral of income compared to alternative structures.

The use of carried interests is not limited to a particular type of business activity, but can extend to any business in which investors desire to align the interests of managers or other service providers who contribute labor to the partnership's business with the interests of investors. This is achieved by using positive investment yield as the measure of service providers' income. Under the tax rate structure of present law, with lower rates for capital gains and dividends than for ordinary income, this arrangement may be attractive in businesses whose profits include capital gains and dividends.

Capital income or compensation

The primary question is whether the carried interest is a form of compensation for services, or whether it is more similar to a right to income or gain from capital.

In many cases, it is fairly clear whether money is paid for services rendered, on the one hand, or for the use of capital as equity or debt, on the other hand. This distinction can become more difficult, however, in a business activity involving capital assets and individuals' services with respect to the capital assets. Issues relating to the distinction between gains and earnings from investment in property, on the one hand, and income from the performance of services or from other types of businesses, on the other hand, can be found in many areas. The distinction has been a general source of complexity.[990] Distinctions have been established legislatively for

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labor income, for taxable years beginning in 1988, 1989, and 1990, the maximum tax rates of individuals on all income, ordinary as well as capital gain, was 28 percent.

[989] When labor income and capital income are taxed at the same rates, then issues of the character of income (i.e., whether capital or ordinary) are much less significant. Some distinctions between capital and ordinary income would remain, however, even if the tax rate differential were eliminated. Unlike ordinary income treatment, capital gain treatment entitles investors to tax-free return of basis to the extent of basis in the asset. Another difference between ordinary and capital gain treatment is that capital losses are subject to a limitation on deductibility against ordinary income. Issues of timing (i.e., when income is taxed) are not affected by setting capital and ordinary income rates at the same level.

[990] See, e.g., *Comm'r v. Jose Ferrer,* 304 F.2d 125 (2d Cir. 1962), *rev'g* 35 T.C. 617 (1961), involving a disputed distinction between compensation for acting services, on the one hand, and capital gain from the disposition of property rights in the resulting productions, on the other. See also Boris I. Bittker and Lawrence Lokken, *Federal Income Taxation of Income, Estates, and Gifts,* Third Edition, 1999, 3-73.

tax purposes in some instances, for example, a self-created copyright, which is treated as property that is not a capital asset.[991]

If the service provider does not contribute capital, but only his labor, the carried interest arrangement involves the performance of services by the individual whose work gives rise to capital income for owners who have contributed capital. While the individual's economic interests are aligned with those of capital investors in the business to the extent that his compensation is based on the positive investment yield of the business, the individual is nevertheless performing services, not receiving a return on contributed capital. Therefore, it is argued that the income should be taxed as ordinary compensation income.

A variety of arguments that such income should not be treated as ordinary compensation have been advanced, principally in the context of the investment management business.[992] For example, it is argued that the service provider with a carried interest is taking economic risk by working in the business and should therefore not be treated as having ordinary compensation income if the income that would flow through the partnership is eligible for capital gains rates. The notion is that capital gains rates are accorded when risk is taken. The risk argument can be criticized, however, in that the capital gains rates apply to the disposition of capital assets, not to risk-taking in general that does not involve capital assets. Further, the capital gains tax rates apply to the disposition of capital assets that have very little risk, such as the sale of U.S. Treasury debt with a yield close to the risk-free rate of return. Moreover, the capital gains tax rates do not apply to many types of income related to risk-taking. For example, capital gains rates do not apply to employee compensation that is performance-based, contingent on meeting sales targets or other performance measures. To the extent that the service provider is risking his time and effort, but not his money, it is argued that the risk rationale for capital gains treatment does not apply.

Another argument made in opposition to the idea of treating income from a carried interest as ordinary income is that the carried interest gives rise to equity, or capital, termed "sweat equity" or "founder's equity." Present law generally treats gain or loss on sale or exchange of an interest in a business in which the seller worked as from the sale or exchange of a capital asset. This is conceptually correct in that a capital asset has been created, it is argued, and by analogy to present-law treatment, income from a carried interest should not be recharacterized. Nevertheless, present law does not treat operating income from a business (for example, from a barber shop, or a widget manufacturing operation) as capital gain to the extent

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[991] See, e.g., section 1221(a)(3)(A), providing that certain copyrights and other property in the hands of a taxpayer whose personal efforts created the property are not a capital asset and thus are not eligible for capital gain treatment; section 751 (gain on sale of a partnership interest is not capital gain to extent it reflects certain unrealized receivables, including certain rights to payment for services); section 7701(e)(1) (providing for recharacterization of a services contract as a lease in certain situations).

[992] A discussion of this issue in the context of fund managers and fund investors, with references to related articles, appears in Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. See also the related document, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007. These documents are available on the internet at www.jct.gov.

labor contributed to the business creates capital; and the proposal applies to the service provider's share of operating income of a partnership (as well as to gain on disposition of the partnership interest). Furthermore, while the proposal would tax as ordinary income the service provider's share of operating income of the business, the proposal also provides that amounts attributable to invested capital are not recharacterized as ordinary income. Thus, the proposal retains the notion that the service provider's share of capital income from the business, if any, is eligible for capital gains rates.

Separating labor income and capital income

If the service provider contributes capital to the partnership in addition to his labor, it could be argued that teasing apart the capital income and the labor income would be difficult and fact-dependent. This difficulty could make the proposal to tax labor income as ordinary hard to apply and inaccurate in measuring labor income in many cases, perhaps in so many cases as to render the proposal ineffective at taxing labor income as ordinary without changing the treatment of capital income. On the other hand, if other partners have capital interests similar to the service provider's capital interest, it may not be so difficult to identify the return on the service provider's capital interest in the partnership by reference to the other partners' similar capital interests.

The issue of separating labor income from capital income becomes more complex if capital assets of the business are created by the owner's labor in the business. The business owner working in the business may have an increasingly large interest in capital assets of the business as his labor makes the business grow (the owner's "sweat equity"). It could become quite difficult to identify the portion of operating income of the business that is properly allocable to the individual's labor, and the portion allocable to his interest in business capital.[993]

[993] In the context of investment management businesses, this issue has been raised by commentators. *See* New York State Bar Association Tax Section, *Report on Proposed Carried Interest and Fee Deferral Legislation*, Sept. 24, 2008, at 19-52, criticizing the operation of the invested capital rule of section 201 of H.R. 6275; Michael L. Schler, "Taxing Partnership Profits Interests as Compensation Income," *Tax Notes*, May 26, 2008, 829, 846-851, analyzing the invested capital rule of section 611 of H.R. 3996. For other recent commentary, see Carol Kulish Harvey, James B. Sowell, and Deborah Fields, "I Spy an ISPI--Expansive Breadth of Carried Interest Proposals," *Tax Notes,* August 2, 2010; Karen C. Burke, "Back to the Future: Revisiting the ALI's Carried Interest Proposals," *San Diego Legal Studies Paper 09-026*, August 2009; Karen C. Burke, "The Sound and Fury of Carried Interest Reform," *San Diego Legal Studies Paper 09-023*, July 2009; Karen C. Burke, "Fuzzy Math and Carried Interests: Making Two and Twenty Equal 710," *San Diego Legal Studies Paper 09-008*, April 2009; Monte A. Jackel and Robert J. Crnkovich, "Partnership Deferred Compensation and Carried Interests," *Tax Notes*, April 20, 2009, 351; Paul Carman, "Taxation of Carried Interests," *Taxes-The Tax Magazine*, March 2009, 111; Mark P. Gergen, "A Pragmatic Case for Taxing an Equity Fund Manager's Profits Share As Compensation," *Taxes-The Tax Magazine*, March 2009, 139; Joel Scharfstein, "Proposed Carried Interest Legislation: The Interaction of Invested Capital and Book-ups," *Taxes-The Tax Magazine*, March 2009, 151; Gregg. D. Polsky, "Private Equity Management Fee Conversions," *Tax Notes*, February 9, 2009, 743; Philip F. Postlewaite, "15 and 35: Class Warfare in Subchapter K," *Tax Notes*, January 26, 2009, 503; Howard Abrams, "Carried Interests: The Past Is Prologue," *Emory University Law & Economics Research Paper No. 08-32*, September 2008; Raymond J. Elson and Leonard G. Weld, "Taxation of Private Equity Firms: Good Tax Policy or Just Income Redistribution by Congress?," *Taxes-The Tax Magazine*, September 2008, 35; Douglas A. Kahn, "The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest," 62 *Tax Lawyer*, Fall 2008, 1; Chris William Sanchirico, "The Tax Advantage of Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?," 75 *Chicago Law Review*, 2008, 1071; David A.

To simplify the analysis, assume the individual performs about the same amount of services in the business every year, and the business grows annually and generates an increasingly large amount of operating income allocable to the service provider's ownership interest. Should the amount of this operating income that is treated as labor income remain constant because the individual's services remain constant, or should the amount of labor income even grow somewhat as he becomes more experienced and better at the job? Or should the amount of operating income treated as capital income grow in accordance with the growth of the business or the value of the individual's share of the capital assets, even if this results in a reduction or elimination of the amount treated as the individual's labor income (while he is still working at a fairly constant rate)?

Litigation over the issue of reasonable compensation demonstrates that ascertaining the value of personal services is fact-driven and often requires case-by-case analysis, particularly for services of an entrepreneur for which comparables may not be so readily available as for other types of labor.

As an alternative to measuring the labor income, deriving the measure of capital income by comparing other similar capital interests in the partnership may also be difficult in many cases. For example, it is possible that a partnership will not "book up" its assets (i.e., increase the value shown on the partnership's books and records) to reflect the increase in value of the business, for example, if no new partners have been admitted. Thus, it may be difficult to ascertain the relative values of the partnership interests of the service provider and the non-service providing partners. It may be that partners have little or no capital on the books of the partnership, for example, in the situation in which a closely held partnership has borrowed to make distributions, perhaps in an amount exceeding contributed capital. As a result, in these and other fact situations, it is possible that the service partner's interest in partnership capital cannot be readily measured by comparison to other partners' capital interests or even by the more limited yardstick of contributed capital.

One option may be to provide rules to implement this concept of measuring service partners' capital by reference to other partners' capital. Such rules would treat as ordinary income the distributive share of an individual who holds an investment services partnership interest, and would exclude from ordinary income treatment the income and gain attributable to the partner's qualified capital interest. A qualified capital interest is measured by the amount of contributed capital, amounts included in income on receipt of the partnership interest by virtue of section 83, and the partner's share of partnership income and gain that has not been distributed to him. This approach looks to other similar capital interests of partners that do not provide services to determine whether earnings of the service provider are from a qualified capital

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Weisbach, "The Taxation of Carried Interests in Private Equity," 94 *Virginia Law Review*, 2008, 715; Michael S. Knoll, The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income," 50 *William & Mary Law Review*, 2008, 115; Carol Kulish Harvey and Eric Lee, "A Technical Walk Through the Carried Interest Provisions Contained in Chairman Rangel's Tax Reform Proposal," *Taxes-The Tax Magazine*, February 2008, 77; Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," 83 *NYU Law Review*, 2008, 1; James H. Lokey, Jr. and Donald E. Rocap, "Selected Tax Issues in Structuring Private Equity Funds," *62 N.Y.U. Institute,* 2004, 509.

interest and therefore not subject to ordinary tax rates. Advocates may argue that following this model for separating labor income from capital income can work in many situations. On the other hand, it could be said that the capital structure of many partnerships, particularly closely held ones and those in which partners are providing significant services, does not provide classes of partnership interests with similar attributes so that the comparison of the capital interests of the various partners can be straightforwardly analyzed. Thus, such qualified capital interest rules would tend to function more smoothly for some business activities, such as investment partnerships with significant capital contributed by investors, than perhaps they would in less capital-intensive businesses also covered by the President's proposal, which is generally applicable to all service partnership interests. Arguably, alternative rules for measuring service partners' capital would need to be developed to take account of the broad scope of the proposal.

A related question involves whether it is appropriate for the proposal to provide a distinction between income from labor and income from capital upon sale or exchange of the individual's interest in the business at a gain. Present law generally allows capital gain treatment for this type of "sweat equity" on sale or exchange of an interest in a business; such an interest is generally treated as a capital asset.

The same sets of questions arise if the business is not successful and generates operating losses and a loss upon sale or exchange of the service performer's interest in the business. Present law generally treats operating income and operating losses of a business as ordinary, so the question as it relates to net operating income primarily involves the employment tax impact of the proposal.[994]

Employment (or self-employment) tax and additional HI tax

A corollary issue relates to the employment tax treatment of income received under a carried interest. Because dividends and capital gain are not subject to employment taxes under present law,[995] the desire to avoid employment or self-employment tax, and at higher income levels to avoid the application of the 2.9 percent hospital insurance portion of the tax (which is not subject to an income cap), may motivate taxpayers to structure payments through carried interests. However, to the extent income from carried interests is viewed as labor income, failing to subject these amounts to employment or self-employment tax, while other compensation is subject to such taxes, can lead to economic inefficiency and to distortion.[996]

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[994] If the business is a partnership, generally partners are subject to self-employment tax on net income of the business, which takes into account operating losses in determining the amount of net earnings from self-employment.

[995] However, for taxable years beginning after 2012, in the case of an individual, estate, or trust, an unearned income Medicare contribution tax is imposed a rate of 3.8 percent on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount.

[996] The inefficiency arises because the taxpayer is motivated to choose the form of business with the highest after-tax return, potentially foregoing the activity or structure with the highest pre-tax return, which would maximize the societal benefit (economic efficiency). In addition, the cost of tax planning to achieve the highest after-tax return can be viewed as distortive, diverting resources away from other productive business activities.

In the case of taxpayers subject (after 2012) to the 3.8 percent unearned income Medicare tax, consideration would have to be given to the treatment under that provision of income that is recharacterized as ordinary under this proposal. If income is treated as ordinary because it is services income, then arguably, the exception from the 3.8 percent tax for certain active businesses should apply. On the other hand, if that exception is intended to benefit small business, an argument could be made that no exception should apply in the case of carried income that exceeds some high level.

<u>Issues relating to complexity, administrability, and scope of the proposal</u>

<u>Additional complexity</u>

Characterizing income from carried interests as ordinary compensation income arguably introduces significant additional complexity to the already complex tax law relating to partnerships. The additional complexity arises from the potential need to identify and separate labor income from capital income, to identify comparable capital interests among partners (especially in cases in which the partnership does not have distinct classes of capital interests), and to ascertain and "book up" the value of the partnership in more situations than under present law, for example. The proposal may cause sophisticated taxpayers to engage in tax-motivated restructuring of current and future business arrangements seeking to avoid the tax cost of ordinary income treatment to the partner providing services. The additional complexity and the tax-motivated behavioral responses to such a change in the tax rules arguably create inefficiencies and distortions in the economy that reduce overall productivity.

Less sophisticated taxpayers engaged in business in partnership form may unknowingly violate the proposal due to its potential complexity and difficulty of application. For example, in the case of a small business in partnership form whose capital structure does not lend itself to comparison of similar capital interests, the proposal may not function effectively to exclude from ordinary income treatment the income from the service provider's capital interest in the partnership; this analysis could be complex. Thus, the proposal could be criticized as a trap for the unwary in the case of unsophisticated taxpayers.

Nevertheless, the preference for simplicity in the tax law must be balanced with fairness and accuracy of income measurement. The perception that taxpayers with income from different categories of personal services are taxed at disparate rates may increase noncompliance among taxpayers who believe that they are over-taxed or who believe that the tax system is inherently unfair.

<u>Administrability</u>

The proposal could be criticized as likely to require many individual taxpayers to analyze their circumstances and possibly file forms or statements that give rise to little or no change in tax liability. It could also encourage some sophisticated taxpayers to engage in tax planning behavior that gives rise to economic distortions and consumes resources that could be devoted to other productive business activity. On the enforcement side, the proposal may require disproportionate audit resources due to the complex and fact-specific analysis that could be needed to determine compliance. On the other hand, it is possible that administrative guidance or procedures could be developed to minimize the impact of the proposal on taxpayers that are not likely to be subject to it.

Scope of the proposal

The principle of horizontal equity in the tax law (that similarly situated taxpayers should be subject to similar tax burdens) suggests that labor income of all individual taxpayers should be taxed at comparable rates, whether it is earned through a partnership or directly. Thus, the principle of horizontal equity would dictate that the proposal correctly applies to all partners.

Advocates may argue that a safe harbor or carve-out for partnerships considered small enough to be unsophisticated, perhaps based on revenues, asset size, number and wealth of partners, or a combination of these or other factors, could mitigate the impact of the proposal's complexity on small businesses. However, identifying such a threshold may not be obvious, resulting in potential arbitrariness and either over- or under-inclusiveness. The proposal does not explicitly provide such a carve-out, nor would such a carve-out necessarily be simple in application.

In a similar vein, it may be argued that very few partners outside the asset management business − due to the nature of their business assets and activities − can convert material amounts of labor income to capital gains and dividends, thus lowering the tax rate and avoiding employment and self-employment tax that applies to individuals who earn labor income directly. Most business activities are not so inherently conducive to such conversion and avoidance. Thus, it is argued, it would be preferable to limit the scope of the proposal to businesses involving significant capital such as investment management services, rather than to extend ordinary income and employment tax treatment to service-providing partners in any business. Operating income of most businesses is already ordinary income under present law. Thus, as a practical matter, the proposal's effect is arguably to impose self-employment tax on operating income that is already taxed at ordinary income tax rates, and to treat gain on sale or exchange of the partnership interest as ordinary income rather than capital gain.

It may be noted that these income tax issues would disappear or be mooted, including the most basic issue of whether the service partner's income is from labor or capital, if labor income and capital income were taxed under the same rate schedule. If the tax rate schedule were the same for all types of income of individuals, horizontal equity would be satisfied and there would be no income tax impetus for the proposal. In 1986, following enactment of the Tax Reform Act of 1986, the tax rate structure provided the same tax rates for these items, although lower rates for specified income types were added to the law soon thereafter. However, the policy implications of such a rate shift, and the corollary changes that might be necessitated, raise many broader issues than the proper income tax treatment of service-providing partners. Further, the employment (or self-employment) tax issue would not be addressed by equalizing income tax rates.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.

K. Modify the Cellulosic Biofuel Producer Credit

A provision substantially similar to the President's fiscal year 2011 budget proposal was enacted as section 1408 of H.R. 4872, the Health Care and Education Reconciliation Act of 2010.[997]

[997] Pub. L. No. 111-152.

L. Eliminate Advance Earned Income Tax Credit

A provision substantially similar to the President's fiscal year 2011 budget proposal was included in H.R. 1586, which was signed into law by the President on August 10, 2010.

M. Deny Deduction for Punitive Damages

Present Law

A deduction is allowed for all ordinary and necessary expenses paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[998] The IRS has ruled that amounts paid as punitive damages incurred by the taxpayer in the ordinary conduct of its business operations are deductible as an ordinary and necessary business expense under section 162.[999] A deduction is not allowed, however, for any payment made to an official of any government or governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[1000] In addition, under section 162(f), no deduction is allowed for any fine or similar payment made to a government for violation of any law.[1001] The enactment of section 162(f) in 1969 was intended to codify existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that allowance of the deduction would "frustrate sharply defined national or state policies proscribing particular forms of conduct."[1002] Further, no deduction is allowed for two-thirds of the damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.

In general, gross income does not include amounts received on account of personal injuries or sickness.[1003] This exclusion generally does not apply to punitive damages.[1004]

Description of Proposal

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

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[998] Sec. 162.

[999] Rev. Rul. 80-211, 1980-2 C.B. 57.

[1000] Sec. 162(c).

[1001] Sec. 162(f).

[1002] S. Rep. 91-552, 91st Cong., 1st Sess. 273-74 (1969), referring to *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35 (1956)). In a series of cases, the Supreme Court had disallowed a deduction if allowing the deduction would "frustrate sharply defined national or state policies proscribing particular forms of conduct." *Commissioner v. Heininger*, 320 U.S. 467, 473 (1943). The Supreme Court further clarified that the "policies frustrated must be national or state policies evidenced by some governmental declaration of them" (*Lilly v. Commissioner*, 343 U.S. 90, 97 (1952)) and the "test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction" (*Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35 (1956)).

[1003] Sec. 104(a).

[1004] Pub. L. No. 104-188; *K.M. O'Gilvie v. U.S.*, 519 U.S. 79 (1996).

Effective date.–The proposal is effective for punitive damages paid or incurred after December 31, 2011.

Analysis

Proponents of the proposal argue that allowance of a tax deduction for punitive damages undermines the role of punitive damages in deterring and penalizing the activities or actions for which the punitive damages were imposed.[1005] Thus, proponents argue that, as a matter of public policy, punitive damages should not be deductible, because punitive damages deducted as an ordinary and necessary business expense reduce a taxpayer's taxable income, and correspondingly its Federal income tax liability.[1006] This deduction essentially transfers a portion of the cost of the punitive damages to the Federal government, thereby undermining the effectiveness of the punitive damages as a deterrent.[1007]

Those advocating denial of a deduction for punitive damages also note that the provision is easily administrable: the determination of the amount of punitive damages generally can be made by reference to pleadings filed with a court, and such determination is already made by plaintiffs in determining the portion of any payment that is taxable.

Opponents of the proposal argue that a deduction should be allowed for all ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business in order to properly measure the income of the taxpayer. They argue that disallowance of punitive damages would result in the taxpayer paying taxes on amounts in excess of his income, essentially imposing an additional direct Federal fine.[1008] Opponents also note that determining the amount of any punitive damages will be difficult in many cases, especially where the payment arises from the settlement of a claim.[1009] A similar issue arises in cases where compensatory damages are too difficult or too costly to accurately calculate, with the result that the punitive damages may have a compensatory element.[1010]

[1005] Kimberly A. Pace, "The Tax Deductibility of Punitive Damages: Who Should Ultimately Bear the Burden of Corporate Misconduct?" 47 Alabama Law Review 826, 863-861 (1968).

[1006] *Ibid*. See also, Catherine M. Del Castillo, "Should Punitive Damages Be Nondeductible? The Expansion of the Public-Policy Doctrine," 68 Texas Law Review 819, 838 (1990).

[1007] See, e.g., New York State Bar Association Tax Section, "The Deductibility of Punitive Damages," 2001 TNT 213-21 (Nov. 26, 2001), noting that "A principal point of punitive damages is to "send a message" for past bad conduct, making them more akin to criminal punishment. They are an "unusual remedy to punish unusually serious misconduct" and are awarded only against defendants who have been "really mean" or "really stupid."" [Citations omitted.]

[1008] Eric M. Zolt, "Deterrence Via Taxation: A Critical analysis of Tax Penalty Provisions," 37 UCLA Law Review, 343, 351 (1989).

[1009] W. Kip Viscusi, "The Challenge of Punitive Damages Mathematics," 30 Journal of Legal Studies 313, 342-43 (2001).

[1010] Robert W. Wood, "Why Punitive Damages Should Remain Deductible," 124 Tax Notes 149 (July 13, 2009).

Others question whether punitive damages serve as a deterrent and, therefore, whether the disallowance of a deduction would approximate the optimal penalties to deter certain behaviors in the most efficient manner.[1011] Moreover, some question whether reliance on the Federal tax system to influence societal objectives is more efficient than non-tax legislative or regulatory actions or market forces.[1012]

Some might argue that the judicial public policy doctrine obviates the need for a statutory provision limiting deductibility of punitive damages. They would contend that the judicial doctrine is more flexible than a statutory provision, and targets the most egregious cases. Others might counter that, based on the lack of cases limiting a deduction for punitive damages, the judicial doctrine is not serving as an effective deterrent to the behaviors for which the damages are assessed. They might argue that a statutory denial of a deduction for punitive damages provides certainty and enhances compliance with the policies intended to be promoted by the imposition of punitive damages.

Prior Action

Substantially identical proposals were included in the President's budget proposals for fiscal years 2000, 2001, and 2010.

[1011] Zolt, supra at 360-374.

[1012] The New York State Bar Association Tax Section, "The Deductibility of Punitive Damages," 2001 TNT 213-21 (Nov. 26, 2001).

N. Repeal the Lower-of-Cost-or-Market Inventory Accounting Method

Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the "first-in, first-out" ("FIFO") method which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the "last-in, last-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under the cost method or the "lower-of-cost-or-market" ("LCM") method.[1013] Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Additionally, "subnormal goods", defined as goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to net selling price, under either the cost or LCM method.

Description of Proposal

The proposal repeals the LCM method and the write down for subnormal goods. Appropriate wash-sale rules would be provided to prevent taxpayers from circumventing the prohibition. The proposal is treated as a change in method of accounting with any resulting section 481(a) adjustment taken into income ratably over four taxable years beginning with the year of change.

Effective date.–The proposal is effective for taxable years beginning after 12 months from the date of enactment.

Analysis

Under present law, income or loss generally is not recognized until it is realized.[1014] In the case of a taxpayer that sells goods, income or loss generally is realized and recognized when the goods are sold or exchanged. The LCM method and the write down for subnormal goods under present law represent exceptions to the realization principle by allowing the recognition of

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[1013] Treas. Reg. sec. 1.471-2(c).

[1014] The most notable exception to this is the mark-to-market rule of section 475, which requires dealers in securities to recognize gain or loss on the securities (other than securities held for investment) "as if such security were sold for its fair market value on the last business day of [the] taxable year."

losses without a sale or exchange. In addition, these methods are one-sided in that they allow the recognition of losses, but not gains, even if the items of inventory recover their value in a subsequent year.

Nonetheless, the LCM method and the write down for subnormal goods have long been accepted as in accordance with generally accepted accounting principles ("GAAP") used in the preparation of financial statements and have been allowed by Treasury regulations for tax purposes since 1918. However, the mechanics of the tax rules differ from the financial accounting rules. Moreover, the conservatism principle of GAAP generally requires the use of the LCM method and the write down of subnormal goods so the inventory reflected on a company's balance sheet is not overstated relative to realizable values. There is no similar principle under Federal income tax law.[1015]

Prior Action

A similar proposal for the repeal of the LCM method and subnormal goods write down was included in the President's budget proposals for fiscal years 1997, 1998, 1999, 2000, 2001, and 2010.

[1015] See, e.g., *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), wherein the Supreme Court noted, "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested…The primary goal of the income tax system, in contrast, is the equitable collection of revenue…Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable." [Citations omitted.]

O. Reduce the Tax Gap and Make Reforms

1. Require information reporting on payments to corporations

A provision substantially similar to the President's fiscal year 2011 budget proposal was enacted as part of section 9006 of the Patient Protection and Affordable Health Care Act ("PPACA").[1016]

2. Require information reporting for rental property expense payments

Present Law

A variety of information reporting requirements apply under present law.[1017] 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.[1018] Reportable payments include compensation for both goods and services, and may include gross proceeds. Certain enumerated types of payments that are subject to other specific reporting requirements are carved out of reporting under this general rule.[1019]

One such regulatory exception carved out payments to corporations, but was expressly overridden by the addition of new section 6041(h) by section 9006 of PPACA.[1020] New section 6041(h) expanded information reporting requirements to include gross proceeds paid in consideration for property and to subject payments to corporations to all of the reporting requirements under section 6041. 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.[1021] The regulations generally except from reporting payments to exempt organizations,

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[1016] Pub. L. No. 111-148, sec. 9006 (effective for payments made after December 31, 2011). Section 9006 of PPACA also expanded the information reporting requirements to include gross proceeds paid in consideration for property. An identical proposal concerning information reporting on payments to corporations was contained in the President's Fiscal Year 2010 Budget Proposal. For a description of Pub. L. No. 111-148, sec. 9006, see Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as amended, in combination with the Patient Protection and Affordable Care Act, (JCX 18-10) March 21, 2010.

[1017] Secs. 6031 through 6060.

[1018] 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).

[1019] Sec. 6041(a) requires reporting "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 dividends.

[1020] Treas. Reg. sec. 1.6041-3(p); Pub. L. No. 111-148, sec. 9006 (effective for payments made after December 31, 2011).

[1021] Sec. 6041(d). Specifically, the recipient of the payment is required to provide a Form W-9 to the payor, which enables the payor to provide the recipient of the payment with an annual statement showing the aggregate governmental entities, international organizations, or retirement plans. Additionally, the requirement that businesses report certain payments is not applicable to persons engaged in a passive investment activity. Thus, 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 such requirement.

Persons engaged in certain real estate transactions generally must report the gross proceeds paid from such transactions.[1022] 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.[1023]

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.[1024]

A person that fails to comply with the information reporting requirements is subject to penalties, which may include a penalty for failure to file the information return,[1025] for failure to furnish payee statements,[1026] or for failure to comply with other various reporting requirements.[1027]

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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 investment 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.

[1022] Sec. 6045(e) requires reporting by real estate brokers, persons responsible for closing, and others designated in regulations, but excepts from reporting sales of principal residences for $250,000 or less ($500,000 for married persons).

[1023] 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.

[1024] Sec. 6050H. This information is provided on Form 1098.

[1025] 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.

[1026] 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.

[1027] 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.

Description of Proposal

The proposal provides that recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making payments of $600 or more to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income are required to provide an information return (typically Form 1099-MISC) to the IRS and to the service provider. Exceptions to this reporting requirement are made for particularly burdensome situations, such as for taxpayers (including members of the military) who rent their principal residence on a temporary basis, or for those who receive only small amounts of rental income.

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

Prior Action

A similar proposal was included in the President's budget proposal for fiscal year 2010.

Analysis

Real estate rentals present one of the sectors of the economy for which there is currently little or no information reporting, despite the existence of a variety of information reporting requirements under present law.[1028] 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 failure to require reporting with respect to rental property income or expenses has previously been identified as a contributor to the tax gap. For example, GAO has estimated that the net income from rental property is reported incorrectly one out of two times, contributing to a tax gap in 2001 of more than $12 billion.[1029] Moreover, misreporting of rental real estate expenses was the most common type of rental real estate misreporting.[1030]

Based on these statistics, and because third-party information reporting is one of the principal methods of improving tax compliance, proponents argue that information reporting by taxpayers receiving rental income and deducting expenses on rental activities would reduce opportunities for error and fraud. When such payors are required to provide information with respect to taxable payments to the IRS, the likelihood that the recipient will properly include the payment in income greatly increases.[1031] The increased reporting of payments to those who

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[1028] Secs. 6031 through 6060.

[1029] Government Accountability Office, *Tax Gap: Actions that Could Improve Rental Real Estate Reporting Compliance,* GAO-08-956, August 2008.

[1030] *Ibid*, p. 13 ("For taxpayers who did not substantiate expenses, some may have incurred the expenses they could not document while other taxpayers may simply have made up expenses").

[1031] See, http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf.

provide services with respect to rental property will assist such contractors in properly reporting their income. Thus, requiring that a rental income recipient report on payments made to service providers (such as plumber, painter, or accountant) in the course of earning rental income would improve tax compliance.

Similarly, proponents may argue that requiring taxpayers to file information returns with respect to certain rental property expenses also may deter such taxpayers from reporting expenses they did not incur. Taxpayers who previously may have overestimated rental expenses will be required to maintain better documentation of such expenses to report them to the payee. Furthermore, the need to report with respect to the payee, and to provide a copy to the IRS, creates a record of such expenses that may subsequently be used upon IRS examination.

Opponents may argue that the potential benefits of expanding the information reporting requirement do not outweigh the burdens of compliance and the additional cost and complexity of complying with the Code. First, taxpayers, as well as paid preparers, would need to spend time educating themselves as to the new filing requirements. Taxpayers would also be required to collect various items of information, such as social security numbers, or taxpayer identification numbers, from the various payees. Further, increased costs would be incurred for mailing Forms 1099 and for hiring outside assistance to the extent that rental income recipients seek to ensure that they are correctly complying with the law. Proponents may counter that these requirements apply only with respect to payments of $600 or more to a single payee, which will likely mitigate the additional compliance burden.

Opponents may also argue that this proposal places an increased administrative burden and additional costs on the IRS to make taxpayers aware of the new requirements because of the potential for penalties for failures to comply with information reporting requirements. To lessen the impact of the potential penalties, the new information reporting requirements could be subject to a transition rule under which penalties would be waived for late filings for the first taxable year such requirements are effective.[1032]

To further lessen the impact of potential penalties and the reach of the reporting requirements, opponents may argue that the proposed exception for temporary rentals should be spelled out specifically so the rule is clear for taxpayers. For example, the proposal could except a residence of a taxpayer which is used as a residence within the meaning of section 280A(d)(1) of the Code. This specific exception may provide proponents an argument that rental income recipients which do not meet this exception were likely already maintaining sufficient documentation tracking their rental income and rental expenses such that the new requirements should not create a significant burden.

[1032] Government Accountability Office, *Tax Gap: Actions that Could Improve Rental Real Estate Reporting Compliance,* GAO-08-956, August 2008.

3. Require information reporting for private separate accounts

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[1033] Similar favorable tax treatment is generally accorded an annuity or endowment contract. However, under the investor control doctrine, the holder of a variable life insurance or annuity contract is treated as the owner of the assets (such as mutual fund shares) underlying the contract if the holder's ability to direct the investment of those assets constitutes sufficient control over individual investment decisions.[1034]

Life insurance companies generally maintain assets that support liabilities under insurance contracts in a general account, or a separate account (in the case of certain types of contracts such as variable contracts). Present law imposes asset diversification requirements on separate accounts with respect to variable contracts. Under these diversification requirements, a variable contract that is based on a separate account is not treated as an annuity, endowment or life insurance contract for which investments made by the separate account are not adequately diversified (as prescribed in Treasury regulations).[1035] Separate financial reporting to State insurance regulators under statutory accounting rules is generally required for separate accounts, and separate financial statements, registration statements, and other reports may be required under Federal securities laws for separate accounts. For Federal income tax purposes, income, gain and loss of a separate account of a life insurer is reported on the Federal income tax return of the life insurer.

Description of Proposal

The proposal imposes reporting requirements with respect to a life insurance, endowment or annuity contract, any portion of the cash value of which is invested in a private separate account, if the investment represents at least 10 percent of the value of the account.

[1033] This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includable in income, to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured (sec. 101(g)).

[1034] See Rev. Rul. 81-225, 1981-2 C.B. 13; *Christofferson v. U.S.*, 749 F.2d 513 (8th Cir. 1984); Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2007-7, 2007-1 C.B. 468.

[1035] Section 817(h).

For this purpose, a private separate account is defined as any separate account of an insurance company with respect to which related persons hold annuity, endowment or life insurance contracts whose aggregate cash values represent at least 10 percent of the value of the assets in the separate account. The determination of whether related persons hold contracts whose aggregate cash values constitute at least 10 percent of the value of the assets in the separate account is made quarterly.

The proposal requires a life insurance company maintaining a private separate account to report to the IRS with respect to each such contract the taxpayer identification number of the contract holder, the policy number, the amount of inside buildup, the total contract account value, and the portion of the total contract account value for each such contract that is invested in one or more private separate accounts of the life insurance company.

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

Analysis

The proposal reflects a concern that private separate accounts of life insurance companies may function to allow annuity, endowment, and life insurance contract holders to defer tax on investments that should be payable currently because the contract holders have control over the underlying investments. Proponents of the proposal argue that reporting to the IRS of information about the private separate accounts and the contracts that are based on them is needed to permit investigation of whether investor control is sufficient that the arrangement should be treated as direct holding of the assets, rather than holding of an annuity, endowment or life insurance contract, the inside buildup on which is tax-free. Without detailed reporting of information about the contracts and the accounts, identification and analysis of these arrangements is more difficult and leads to inefficient use of government resources.

However, opponents may assert that the reporting requirements are significantly broader than needed to identify cases in which the investor control doctrine might apply. If any reporting requirement is needed, it should be merely a notation that the arrangement exists. It is unclear that the reported information could actually be processed by the IRS in a useful manner; possibly the information might even be disregarded. In fact, reporting requirements designed merely to permit IRS identification of arrangements that might be challenged by the IRS is wasteful not only of government resources but also of taxpayer resources. Opponents may further argue that the detailed reporting requirements of the proposal are burdensome for taxpayers and give rise to excessive administrative costs without targeting any identified tax abuse. On the other hand, reporting may be a more efficient use of resources so that arrangements that require further investigation can be identified for audit.

Opponents may believe that the definition of a private separate account is broader than needed to achieve the goal of flagging questionable arrangements for audit. If the purpose of the definition is to identify an insurance company separate account that is owned principally by a particular person or group of related persons that might have the ability to direct the investments in the account in violation of the investor control doctrine, then the proposal's 10-percent ownership threshold could be criticized as too low or as arbitrary.

Advocates of the proposal may counter that the definition is for purposes of a reporting requirement, not a substantive provision of law. Taxpayers who are confident that their arrangement does not violate the investor control doctrine should not be concerned about reporting it.

Opponents may also take the position that the investor control doctrine perhaps is unlikely to apply with respect to private separate account contracts. One argument for this position might be that the diversification requirements of section 817(h) have superceded the investor control doctrine. Nevertheless, others may point out that the rules of section 817(h) and the investor control doctrine continue to coexist, as evidenced by the publication of several revenue rulings on the scope of the investor control doctrine long after the enactment of the section 817(h) diversification requirements.[1036] Another argument for this position is that the arrangements under private separate accounts are carefully monitored by the contract holder and the life insurance company so that they do not violate either the investor control doctrine or the diversification requirements. On the other hand, proponents of reporting assert that violations of the investor control doctrine, if they occur, arguably are more likely to take place in the context of private separate accounts, as compared to other types of insurance company accounts.

Prior Action

A similar proposal was included in the President's fiscal year 2001 and 2010 budget proposals.

4. Require a certified taxpayer identification number from contractors and allow certain withholding

Present Law

Information reporting

A taxpayer identification number ("TIN") is an identification number used by the IRS for purposes of tax administration. A TIN must be furnished on all returns, statements, or other tax related documents.[1037] Additionally, a person ("payee") must furnish his or her TIN to another person ("payor") if the payor is required to file a return, statement, or other tax related document that must include the payee's TIN.[1038]

A variety of information reporting requirements apply under present law.[1039] The primary provision governing information reporting by payors requires an information return by

[1036] See Rev. Ruls. 2003-91, 2003-92, and 2007-7, *supra*. Section 817(h) was enacted in 1984, in section 211 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369.

[1037] Sec. 6109(a)(1).

[1038] Sec. 6109(b).

[1039] Secs. 6031 through 6060.

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.[1040] Reportable payments include compensation for both goods and services, and may include gross proceeds. Certain enumerated types of payments that are subject to other specific reporting requirements are carved out of reporting under this general rule by regulation.[1041]

One such carveout excepts payments to corporations, but was expressly overridden by the addition of new section 6041(h) by section 9006 of PPACA.[1042] New section 6041(h) expanded information reporting requirements to include gross proceeds paid in consideration for property and to subject payments to corporations to all of the reporting requirements under section 6041. 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.[1043] The regulations generally except from reporting payments to exempt organizations, governmental entities, international organizations, or retirement plans. Additionally, the requirement that businesses report certain payments is not applicable to persons engaged in a passive investment activity.

Government entities are specifically required to make an information return, reporting certain payments to corporations as well as individuals. Moreover, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).[1044]

[1040] 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).

[1041] Sec. 6041(a) requires reporting "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 dividends.

[1042] Treas. Reg. sec. 1.6041-3(p); Pub. L. No. 111-148, sec. 9006 (effective for payments made after December 31, 2011).

[1043] 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 investment 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.

[1044] Sec. 6050M.

As noted above, a payor required to make a return with respect to a payee must ask the payee for his identifying TIN and include that number in the return.[1045] Typically, if there is an error in the TIN-name combination furnished by the payee, the IRS may disclose such error to the payor. If the IRS has notified a payor of an incorrect payee TIN, the payor must withhold taxes from any reportable payments to the payee.[1046]

Withholding

Many payments are not subject to withholding under present law. For example, no tax is generally withheld from payments made to workers who are not classified as employees (i.e., independent contractors). Since contractors are not subject to withholding, they may be required to make quarterly payments of estimated income taxes and self-employment taxes. The contractor is required to pay any balance due when the annual income tax return is subsequently filed.

Description of Proposal

Certified TINs

Under the proposal, a contractor receiving payments of $600 or more in a calendar year from a particular business[1047] is required to furnish to the business the contractor's certified TIN. A business is required to verify the contractor's TIN with the IRS, which is authorized to disclose, solely for this purpose, whether the certified TIN-name combination matches IRS records.[1048]

Withholding

If a contractor fails to furnish an accurate certified TIN, the business (payor) is required to withhold a flat rate percentage of gross payments. Contractors receiving payments of $600 or more in a calendar year from a particular business could require the business to withhold a flat rate percentage of their gross payments, with the flat rate percentage of 15, 25, 30 or 35 percent being selected by the contractor.

Effective date.−The proposal is effective for payments made to contractors after December 31, 2010.

[1045] Sec. 6109(b).

[1046] Sec. 3406(a)(1).

[1047] "A particular business" likely refers to service recipients (including any governmental unit) who are required to report the payments under current section 6041A.

[1048] The IRS will not provide the correct TIN in response to an incorrect TIN submission; the IRS will state only that the information does not match IRS records.

Analysis

The IRS receives a significant number of information returns each year containing missing or incorrect name and TIN information.[1049] In general, the compliance rate is high when there is both information reporting and withholding. For example, the rate of misreporting of wages and salaries is 1.2 percent.[1050] The IRS has indicated that amounts subject to third-party information reporting but not withholding have a higher misreporting percentage. For example, the misreporting rate for interest and dividends is 4.5 percent.[1051] Amounts generally subject to neither withholding nor third party information reporting, such as sole proprietor income and "other income," are the most likely to be misreported. The IRS has indicated that the net misreporting percentage for this group of items is 53.9 percent.[1052]

In light of these statistics, proponents may argue that compliance will be enhanced if payors have the ability to verify payee TINs with the IRS prior to filing information returns for reportable payments on behalf of such payees. Because the proposal requires withholding on gross proceeds, rather than taxable income, the proposal may result in excess withholding (because there is no accounting for the standard deduction, itemized deductions, or personal exemptions) on payments for which an accurate certified TIN is not provided. On the other hand, the IRS will have in hand the amounts withheld in the event that the contractor failing to supply the TIN also fails to report the income.

Those opposed to the proposal may argue that to the extent a contractor is a sole proprietor who does not apply for a separate TIN and instead uses his social security number ("SSN"), the contractor may have concerns, such as identity theft, in supplying the SSN to third parties. In the case of a tax-compliant taxpayer, the failure to supply a TIN may result in unnecessary withholding and cause hardship resulting from the decreased cash flow. Further, a payor may be forced to delay making a full payment for a contactor's services while waiting on the IRS to certify the TIN. On the other hand, the fact that income from sole proprietorships is among the categories of income most likely to be misreported may justify placing an additional burden on the compliant, as well as noncompliant to ensure that taxes due and owing are paid.

Those opposed may also argue that giving a contractor the option to impose withholding requirements at varying rates on a business payor that might not otherwise engage in such withholding may impose an administrative paperwork and remittance burden on the payor to the extent it is a unilateral decision. On the other hand, the compliance burden on the contractor might be reduced as funds would be set aside to meet their tax obligations.

[1049] For example, the Branch Chief for the Information Return Processing Branch has indicated that, in 2008, almost thirty million social security numbers filed on information returns (out of slightly over 2 billion forms filed) were unmatchable.

[1050] Testimony of Mark Everson, Commissioner of Internal Revenue, before the Senate Committee on the Budget, *FY 2008 IRS Budget and the Tax Gap*, February 14, 2007, p. 15.

[1051] *Ibid.*

[1052] *Ibid.*

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009, and 2010 budget proposals.

5. Increased information reporting for certain government payments for property and services

Present Law

A variety of information reporting requirements apply under present law.[1053] 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.[1054] Reportable payments include compensation for both goods and services, and may include gross proceeds. Certain enumerated types of payments that are subject to other specific reporting requirements are carved out of reporting under this general rule.[1055]

One such regulatory exception carves out payments to corporations, but was expressly overridden by the addition of new section 6041(h) by section 9006 of PPACA.[1056] New section 6041(h) expanded information reporting requirements to include gross proceeds paid in consideration for property and to subject corporations to all of the reporting requirements under section 6041. 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.[1057] The regulations generally except from reporting payments to exempt organizations, governmental entities, international organizations, or retirement plans. Additionally, the requirement that

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[1053] Secs. 6031 through 6060.

[1054] 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).

[1055] Sec. 6041(a) requires reporting "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 dividends.

[1056] Treas. Reg. sec. 1.6041-3(p); Pub. L. No. 111-148.

[1057] 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 investment 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.

businesses report certain payments is not applicable to persons engaged in a passive investment activity.

Certain government entities also are required to file an information return, reporting certain payments to corporations as well as individuals.[1058] In addition, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).[1059]

Effective for payments made after December 31, 2010, section 511 of the Tax Increase Prevention and Reconciliation Act of 2005[1060] ("TIPRA") imposes new withholding requirements on certain government payments. Specifically, the provision imposes a three percent withholding rate on certain payments to persons providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies).[1061] The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than $100 million of annual expenditures for property or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement. The provision imposes information reporting requirements on the payments that are subject to withholding under the provision.

Failure to comply with the information reporting requirements results in penalties. Those penalties may include a penalty for failure to file the information return,[1062] for failure to furnish payee statements,[1063] or for failure to comply with other various reporting requirements.[1064]

[1058] Sec. 6041A(d)(3)(A).

[1059] Sec. 6050M.

[1060] Pub. L. No. 109-222.

[1061] This provision is effective for payments made after December 31, 2010. Sec. 3402(t).

[1062] 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.

[1063] 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.

[1064] 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.

Description of Proposal

The proposal provides the Secretary with authority to promulgate regulations requiring information reporting on all nonwage payments by Federal, State and local governments to procure property and services. Under the proposal, the Secretary expects to exclude certain categories of payments from the information reporting and backup withholding requirements, including payments of interest, payments for real property, payments to tax-exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

Effective date.−The proposal is effective for payments made by Federal, State and local governments after December 31, 2010.

Analysis

The proposal could enhance compliance with the tax laws by requiring additional information reporting on certain nonwage payments. However, the extent to which the proposal improves compliance will depend on the scope of payments subject to the proposal and any exceptions. For example, under present law, government entities are required to report payments to a service provider when the aggregate of payments to such service provider is $600 or more. The proposal does not specify whether a similar dollar threshold would apply to payments subject to the reporting requirements. Because the extent to which the proposal expands upon present-law requirements is unclear, it is difficult to assess the relative benefits and burdens associated with the proposal.

In addition, payments subject to the proposal are the same type of payments subject to the withholding provision enacted in TIPRA, which applies to payments made after December 31, 2011. The withholding provision in TIPRA can be expected to have a greater impact on compliance than information reporting alone. Some might argue that additional information reporting is appropriate in this instance due to concerns regarding noncompliance by government contractors.[1065]

Imposing additional information reporting requirements will impose new costs on payors. The requirements will increase the recordkeeping and reporting burdens on payors subject to the proposal. Proponents respond that, in many cases, the affected parties already have procedures in place that can be modified to accommodate the additional requirements. For example, present law imposes information reporting requirements on governmental entities. Arguably, the proposal will require only the expansion of existing procedures to satisfy the broader requirements under the proposal, not the creation of wholly new procedures. Similarly, certain Federal payments to vendors of goods or services are subject to continuous levy authority under present law.[1066] Thus, government entities are likely to have existing systems and procedures for

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[1065] Government Accountability Office, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence,* GAO-05-637, June 2005.

[1066] Sec. 6331(h).

deducting and remitting taxes from payments to businesses and individuals that may be tailored to the specific requirements of the proposal. Moreover, to the extent the proposal requires new procedures, such procedures are likely to be similar to those necessary to comply with the withholding provision enacted in TIPRA.

Prior Action

A similar proposal was included in the President's fiscal year 2007, 2008, 2009 and 2010 budget proposals.

6. Increase 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 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 is effective for information returns required to be filed after December 31, 2011.

Analysis

Because the U.S. tax system depends on voluntary compliance, penalties for the failure to comply with tax laws are necessary to encourage and support broad compliance with the tax laws. Penalties serve to establish and validate the standards of behavior set forth by the tax laws themselves, as well as to punish specific departures from such laws. In the absence of penalties, the tax laws would, at best, represent a suggested code of behavior.

Ideally, tax penalties would be set to achieve the following goals: (1) encourage voluntary compliance, (2) operate fairly, (3) deter undesired behavior, and (4) promote efficient and effective administration of the provisions by the IRS.[1067] In other words, penalties should be set sufficiently high to change behavior, but not so high that examiners are reluctant to assess them.[1068]

The information return penalties, in particular, are designed to encourage the filing of correct information returns, even when such returns are filed after the prescribed filing date. Thus, there is a three-tier structure to present-law information return penalties in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure.

Proponents of the proposal argue that the information return penalties have not been increased in many years and, as a result, the penalties are too low to discourage non-compliance. Although the largest companies establish internal procedures to verify compliance with information reporting requirements, the modest amounts of information reporting penalties may make it less costly for mid-sized entities filing large numbers of information returns to incur the

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[1067] See, e.g., Government Accountability Office, *IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts*, GAO-09-567, June 2009. For early theoretical discussions of the economics of crime and tax evasion see Gary S. Becker, "Crime and Punishment: An Economic Approach," *Journal of Political Economy*, 76, March-April 1968, 169-217 and Maurice Allingham and Agnar Sandmo, "Income Tax Evasion: A Theoretical Analysis," *Journal of Public Economics*, 1, November 1972, 323-338. Becker suggests that an optimal system of punishment would set the probability of conviction relatively low to reduce the cost of enforcement while maintaining a sufficiently high penalty to achieve the desired level of deterrence.

[1068] Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap*, September 26, 2006, at http://ustreas.gov/press/releases/reports/otptaxgapstrategy%20final.pdf. See also, Government Accountability Office, *IRS Should Evaluate Penalties and Develop a Plan to Focus its Efforts,* GAO-09-567, June 2009, noting that in certain cases IRS officials recounted instances in which otherwise applicable small penalties were not assessed because the administrative cost of developing facts necessary to support assertion of the penalty was disproportionate to the penalty itself.

maximum penalty than to establish internal compliance procedures and conduct internal audits to verify the accuracy of filed information returns. Those supporting the increase argue that increasing the information return penalties and the cap on such penalties will encourage the filing of timely and accurate information returns, which will in turn improve overall tax compliance.[1069] Most research shows that taxpayer compliance rises with the level of penalties combined with the probability of audit.[1070] Thus, the proposal could be expected to increase compliance to the extent there is not a corresponding decrease in the audit of information returns.

On the other hand, it has been noted that high penalties risk punishing too harshly someone who makes an honest mistake and as a result are inconsistent with the goal of enhancing compliance. In the 2008 Annual Report to Congress, the National Taxpayer Advocate noted the lack of quantitative data that would enable policy makers to determine the efficacy of any new penalties or changes to existing provisions and opined that it may be helpful to consider major review of the penalty regime and its effectiveness in promoting voluntary compliance.[1071] Others have noted that the costs of enforcement are likely to be higher in a system with harsher penalties in order to ensure their consistent and proper application. Furthermore, administration suffers if administrators are reluctant to impose harsher penalties, while higher penalties applied without adequate oversight may inflict damage on taxpayers. For these reasons, the interaction between the probability that a penalty applies and the cost of enforcement should be considered when a penalty rate is adjusted.[1072]

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009 and 2010 budget proposals.[1073]

1069 Research shows that underreported income accounts for the largest portion of the tax gap. Internal Revenue Service, *IRS Updates Tax Gap Estimates,* IR-2006-28, Feb. 14, 2006.

1070 For a review of the literature see Joel Slemrod, "Cheating Ourselves: The Economics of Tax Evasion," *Journal of Economic Perspectives*, 21, Winter 2007, 25-48. See also, e.g., Nehemiah Friedland, Shlomo Maital, and Aryen Rutenberg, "A Simulation Study of Income Tax Evasion," *Journal of Public Economics*, 10, August 1978, 107-116; Charles T. Clotfelter, "Tax Evasion and the Tax Rates: An Analysis of Individual Returns," *Review of Economics and Statistics*, 65, August 1983, 363-373; Robert Mason and Lyle D. Calvin, "Public Confidence and Admitted Tax Evasion," *National Tax Journal*, 37, December 1984, 489-496; Ann D. Witte and Diane F. Woodbury, "The Effect of Tax Laws and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax," *National Tax Journal*, 38, March 1985, 1-14.

1071 National Taxpayer Advocate, "A Framework for Reforming the Penalty Regime," 2008 Annual Report to Congress, Vol. 2 (December 31, 2008).

1072 See Joel Slemrod, "Cheating Ourselves: The Economics of Tax Evasion," *Journal of Economic Perspectives*, 21 Winter 43 (2007).

1073 H.R. 3997, as passed by the House of Representatives on December 18, 2007, included a similar provision.

7. Require e-filing by certain large organizations

Present Law

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[1074] states a Congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

Present law requires the Secretary to issue regulations regarding electronic filing and specifies certain limitations on the rules that may be included in such regulations.[1075] The statute requires that the Secretary mandate electronic filing by all partnerships with more than 100 partners. For taxpayers other than partnerships, the Secretary is prohibited from requiring electronic filing by persons who file fewer than 250 returns during a calendar year. The Secretary may permit, but cannot require, electronic filing of income tax returns of individuals, estates, and trusts. However, income tax returns prepared by specified tax return preparers are required to be filed electronically.[1076] In crafting the required regulations, the Secretary must take into account the ability of taxpayers to comply at reasonable cost.

The IRS requires corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for tax years ending on or after December 31, 2006. Private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns for tax years ending on or after December 31, 2006, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer.

Effective for tax years ending on or after December 31, 2004, the IRS requires corporations with total assets in excess of $10 million to file Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More). Effective for tax years ending on or after December 31, 2006, the Schedule M-3 filing requirement also applies to the following entities with assets in excess of $10 million: S corporations; life insurance corporations; property and casualty insurance corporations; cooperative associations; and partnerships.

[1074] Pub. L. No. 105-206.

[1075] Sec. 6011(e).

[1076] Section 6011(e)(e)(B) defines a "specified tax return preparer" as any return preparer who reasonably expects to file 10 or fewer individual income tax returns.

Description of Proposal

The proposal requires all corporations and partnerships required to file Schedule M-3 to file income tax returns electronically. In the case of certain taxpayers not required to file Schedule M-3 (such as exempt organizations), the proposal provides the Secretary authority to require electronic filing without regard to the present-law 250 return minimum.

The proposal requires the Secretary to balance the benefits of electronic filing against any burden that might accrue to taxpayers. Implementation of the proposal is to take place incrementally to afford adequate time for transition to electronic filing. The Secretary is permitted to provide waivers to taxpayers who cannot meet the electronic filing requirement due to technology constraints, undue financial burden, or other reasons specified in regulations.

Effective date.−The proposal is effective for tax years ending after December 31, 2010.

Analysis

The proposal generally seeks to allow Treasury to issue regulations requiring electronic filing by organizations without regard to the number of returns an organization files during the calendar year. As noted above, under present law, Treasury and IRS are generally precluded from requiring a person to file electronically if that person files fewer than 250 returns during the calendar year.

RRA 1998 set a goal for the IRS to have 80 percent of tax returns filed electronically by 2007. That goal has not been met, as of the 2009 tax filing season.[1077] However, growth in electronic filing is slowing and the IRS has reported that the goal set by Congress will not be achieved.[1078] Providing Treasury and the IRS with greater flexibility to expand the scope of returns that are required to be filed electronically may be helpful to the IRS in achieving the 80 percent goal set by the Congress.

Electronic filing produces a number of benefits both for taxpayers and the IRS, including shorter processing times, fewer errors, and better data. Proponents argue that the efficiencies and cost savings achieved through electronic filing justify expanding such requirements. For example, the GAO has reported that electronic filing has enabled the IRS to close two processing centers, and save 1,600 staff years.[1079] With the widespread adoption of computer technology, proponents contend that mandatory e-filing represents a minimal additional burden to taxpayers.

[1077] GAO reports that for the 2009 season, electronic filing increased to 68 percent of all returns. See, Government Accountability Office, GAO-10-225, *2009 Tax Filing Season: IRS Met Many 2009 Goals, but Telephone Access Remained Low, and Taxpayer Service and Enforcement Could be Improved*. (December 2009).

[1078] See, e.g., Government Accountability Office, GAO-07-27, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings,* November 2006. This report indicates a slowing growth in individual electronic filing for the 2005 return filing season. The number of corporations using electronic filing increased during the same period largely as a result of early adoption of electronic filing by corporations with assets of $10 million or more.

[1079] *Ibid.*

On the other hand, opponents argue that expanding electronic filing mandates will impose additional costs on taxpayers who will be required to submit tax returns and related schedules in a new format. Moreover, most of the costs of electronic filing are borne by taxpayers while all of the benefits accrue to the government. In addition, even if taxpayers have the necessary systems to meet expanded electronic filing requirements, the expected benefits from the proposal only will be realized to the extent the IRS has sufficient resources to effectively analyze the transmitted data.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, 2008, 2009 and 2010 budget proposals.

8. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[1080]

FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent of wages on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($106,800 for 2010). The HI tax rate is, generally, 1.45 percent of wages on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax the HI tax is generally not limited to a specific amount of wages, but applies to all wages. Under PPACA, however, the employee portion of the HI tax was increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount.[1081] Unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

FUTA tax is used to fund programs maintained by the individual States for the benefit of unemployed workers. Under FUTA, employers must pay a tax of 6.2 percent of wages up to the

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[1080] Secs. 3101-3128 (FICA), 3201-3241 (the Railroad Retirement Tax Act), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

[1081] Sec. 3121(a) of PPACA.

FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions mean payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees' remuneration.[1082]

Employers are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Wages paid to employees, and FICA and income taxes withheld from the wages, are required to be reported on employment tax returns and on Form W-2.[1083]

Responsibility for employment tax compliance

Responsibility for employment taxes generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[1084] Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. In other words, the required relationship exists when an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed; rather, it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances. The test of whether an employer-employee relationship exists is often applied in determining whether a worker is an employee or an independent contractor; however, the same test is also used to determine whether a worker is an employee of one person or another.[1085]

[1082] The SUTA Dumping Prevention Act of 2004, Pub. L. No. 108-295, set standards for State law to prevent the practice of "SUTA dumping," a tax evasion scheme where shell companies are formed to obtain low State unemployment insurance tax rates.

[1083] Secs. 6011 and 6051.

[1084] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1(a).

[1085] Issues relating to the classification of workers as employees or independent contractors are discussed in Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes* (JCX-26-07), May 2007. These issues are also discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Vol. II, Part XV.A, at 539-550.

In some cases, a person other than the common-law employer may be liable for employment taxes. For example, if wages are paid to an employee by a person other than the employer and the payor, rather than the employer, has control of the payment of the wages, the payor is responsible for complying with the applicable employment tax requirements.[1086] In addition, certain designated agents are jointly and severally liable with the employer for FICA tax and income tax withholding with respect to wages paid to the employer's employees (the "designated agent" rule).[1087] These designated agents prepare and file employment tax returns using their own names and employer identification numbers.[1088] In contrast, reporting agents (often referred to as payroll service providers) are generally not liable for the employment taxes reported on their clients' returns. Reporting agents prepare and file employment tax returns for their clients using the client's name and employer identification number.

Employee leasing arrangements

An employee leasing company (sometimes called a professional employer organization) provides employees to perform services in the businesses of the employee leasing company's clients, which are usually small and medium-sized businesses. In many cases, the employees already work in the client's business as the client's employees prior to entry into the employee leasing arrangement. The terms of a typical employee leasing agreement provide that the employee leasing company is responsible for paying the employees and for the related employment tax compliance. While the employees may legally be the employees of the client, rather than of the employee leasing company, clients typically rely on the employee leasing company to satisfy applicable employment tax obligations.[1089] Despite these contractual

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[1086] Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the employee's share of FICA from wages); and *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA). The mere fact that wages are paid by a person other than the employer does not necessarily mean that the payor has control of the payment of the wages. Rather, control depends on the facts and circumstances. See, e.g., *Consolidated Flooring Services v. United States*, 38 Fed. Cl. 450 (1997), and *Winstead v. United States*, 109 F. 3d 989 (4th Cir. 1997).

[1087] Sec. 3504. The designated payroll agent rules do not apply for FUTA purposes.

[1088] The employer's name, address, and employer identification number, as well as the agent's, are provided when the agent is designated by the employer. Form 2678 is used to designate an agent.

[1089] As discussed in the text above, the issue of whether a worker is an employee of a particular entity for employment tax purposes is generally determined by reference to the Treasury regulations under sections 3121(d), 3306(i), and 3401(c), which incorporate the common law definition of employee. This common law definition also generally applies for purposes of determining who is an employee for retirement plan purposes. In some cases, a professional employer organization may provide benefits to workers who are legally the employees of the client. The IRS has issued guidance with respect to the application of the retirement plan rules in such cases. For example, Revenue Procedure 2002-21, 2002-1 C.B. 911, provides that employees of a client may be covered under a multiple employer defined contribution plan of the professional employer organization if the client adopts the plan and certain other requirements are satisfied. *See also* Rev. Proc. 2003-86, 2003-2 C.B. 1211.

provisions, the questions of whether the employee leasing company is, in fact, the common law employer of the employees (and therefore generally responsible for employment taxes) or whether the employee leasing company is a designated agent of the employer (and therefore joint and severally liable for employment taxes), is often the subject of dispute following a failure to remit employment taxes due.

Description of Proposal

The proposal contemplates the establishment of standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes and standards for holding employee leasing companies solely liable for such taxes if they meet specified requirements. Details of the proposal have not yet been provided.

Effective date.−The proposal is effective for employment tax returns filed with respect to wages paid after December 31, 2010.

Analysis

In the absence of a detailed proposal, the following analysis discusses general issues relating to employee leasing companies and employment taxes.

In a 2001 study of the tax gap, the IRS estimated that the portion of the gap attributable to FICA and FUTA taxes was $15 billion for the 2001 tax year.[1090] An additional portion of the tax gap is attributable to income taxes due on unreported wages. The proposal is aimed at improving employment tax compliance by businesses.

In an employee leasing arrangement, clients typically rely on the leasing company to comply with the applicable employment tax requirements. This is the case regardless of whether legal responsibility for employment tax compliance rests with the leasing company or with the client. In such a case, absent an audit, the IRS generally has no way of knowing whether the leasing company or the client is the employer, or even that a leasing arrangement exists. If neither the leasing company nor the client complies with the applicable employment tax requirements, it may be difficult to determine which party is liable for compliance.

Uncertainty as to who is responsible for employment tax compliance in an employee leasing arrangement may mean that, as a practical matter, no one is held responsible for the payment of employment taxes. Providing clear rules for determining who is liable for employment taxes in employee leasing arrangements would address those issues and could improve compliance. In addition, joint and several liability may make it more difficult for an employee leasing company to avoid employment tax liability with respect to wages paid to leased employees.

Some believe that holding leasing companies solely liable for employment taxes offers a greater likelihood of employment tax compliance than can be expected from clients on an

[1090] IRS news release IR-2006-28 and attachment, February 14, 2006.

individual basis, particularly in the case of clients that are small businesses.[1091] On the other hand, the payroll of a leasing company typically includes the payroll for employees leased to many client businesses, as well as the payroll for employees working directly for the leasing company itself. Accordingly, the failure of a leasing company to comply with employment tax obligations may result in noncompliance on a larger scale than the level of noncompliance that would otherwise occur among client businesses. In addition, the IRS has designated certain transactions involving the designation of an offshore employee leasing corporation as the employer, and therefore the party liable for the payment of employment taxes, as a listed transaction and has communicated its commitment to challenge the tax benefits claimed under these arrangements.[1092] Rules for holding leasing companies solely liable for employment taxes should therefore include adequate standards and procedural safeguards to prevent abuse and to assure that the leasing company will in fact comply with the new rules.

Some argue that existing rules, such as the designated agent rules, are sufficient to permit leasing companies to assume employment tax responsibility and thus there is no need for special rules (such as the proposal) under which only the leasing company is liable for a failure to pay employment taxes. Further, some note that, under a regime where employee leasing companies are solely liable for employment taxes, the IRS may be left without recourse when insufficiently capitalized leasing companies become insolvent and that the existing rules imposing joint and several liability in certain situations provide the IRS with some protection in this regard.

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009 and 2010 budget proposals.

9. Increase certainty with respect to worker classification

Present Law

Different tax treatment for employees and independent contractors

Significant tax consequences for both the service recipient and the worker result from whether a worker is an employee or an independent contractor. An independent contractor is a self-employed individual under the Code for purposes of income taxes and employment taxes. The tax consequences of a worker being an independent contractor, rather than an employee, relate to withholding and employment tax liability, as well as to the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some consequences favor employee status, while others favor independent contractor status. For

[1091] Such proponents observe that an employee leasing company should have an expertise in the proper handling of employee wages since the payment of wages is a core business function of such a company. Apart from employment tax compliance benefits, proponents of placing liability solely on employee leasing companies note that economies of scale permit leasing companies to provide their leased employees with benefits that cannot be provided on an affordable basis by their smaller clients.

[1092] IRS Notice 2003-22, 2003-1 C.B. 851.

example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Employment taxes

Federal Insurance Contributions Act ("FICA") tax

FICA tax applies to employers based on the amount of covered wages paid to an employee during the year. Generally, covered wages means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Certain exceptions from covered wages are also provided. FICA tax is composed of two parts: (1) old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($106,800 in 2010); and (2) Medicare hospital insurance ("HI") tax equal to 1.45 percent of covered wages.

In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer.[1093] The employee portion of the FICA tax generally must be withheld and remitted to the Federal government by the employer.[1094] The employer generally is liable for the amount of this tax whether or not the employer withholds the amount from the employee's wages.[1095] In the event that the employer fails to withhold from an employee, the employee generally is not liable to the IRS for the amount of the tax. However, if the employer pays its liability for the amount of the tax not withheld, the employer generally has a right to collect that amount from the employee. Further, if the employer deducts and pays the tax, the employer is indemnified against the claims and demands of any person for the amount of any payment of the tax made by the employer.[1096]

Federal Unemployment Tax Act ("FUTA")

FUTA tax is used to fund programs maintained by the individual States for the benefit of unemployed workers. Under FUTA, for 2010, employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an

[1093] Sec. 3101. However, under section 9015 of PPACA, for remuneration received and taxable in years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. There is no corresponding increase on the employer portion of FICA.

[1094] Sec. 3102(a).

[1095] Sec. 3102(b).

[1096] *Ibid*.

additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions mean payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees' remuneration.[1097]

Wage reporting and income tax withholding

Income tax withholding applies to wages paid to employees by an employer. An employer is generally liable for income taxes required to be withheld even if the employer fails to withhold.[1098] This liability is only abated if the income taxes against which such tax may be credited are paid by the employee.[1099] However, this abatement does not relieve the employer of any penalty or addition to tax otherwise applicable as a result of any failure to initially deduct and withhold income taxes.[1100]

Wages, and the amount of income tax and FICA taxes withheld from an employee, must be reported on Form W-2.[1101] There is no withholding required with respect to payments by service recipients to independent contractors. However, amounts paid to independent contractors in excess of $600 for a taxable year must be reported on Form 1099.[1102]

Liabilities and penalties imposed on employers for failure to withhold payroll taxes

Section 3505(a) imposes liability for FICA taxes on any person who pays wages directly to an employer's employees. Subject to a limit of 24 percent of the proceeds involved, any person who supplies funds to an employer for the specific purpose of paying wages to the employer's employees is liable under section 3505(b) for the amounts to be withheld if, and only if, the person has notice or knowledge that the employer is not meeting, or cannot meet, its withholding obligations.

The liability for failure to deduct and withhold is mitigated where the failure is due to the employer's treatment of the worker as an independent contractor,[1103] rather than an employee, but only if the failure is not due to an intentional disregard of the duty to deduct and withhold.

[1097] The SUTA Dumping Prevention Act of 2004, Pub. L. No. 108-295, set standards for State law to prevent the practice of "SUTA dumping," a tax evasion scheme where shell companies are formed to obtain low State unemployment insurance tax rates.

[1098] Sec. 3402(a)

[1099] Sec. 3402(d)

[1100] *Ibid*.

[1101] Sec. 6051.

[1102] Sec. 6041.

[1103] Sec. 3509.

Under this reduced liability, the employer's liability for income tax withholding is limited to 1.5 percent of wages, and liability for the employee portion of FICA is limited to 20 percent of the amount actually owed. However, if the employer fails to issue Forms 1099 to employees reporting amounts paid to the employees treated as independent contractors, the liability is increased to three percent of wages for income tax withholding and 40 percent of the employee portion of FICA. In either case, there is no mitigation of liability for the employer portion of FICA, and no credit is provided for any tax paid by the employee or right to claim reimbursement from the employee.

In addition to other penalties provided by law, the Code provides for collection of unpaid withholding, FICA, and FUTA taxes by imposing personal liability on "responsible persons," meaning persons (e.g., officers, employees, and directors) required to collect, truthfully account for, and pay over any tax imposed by the Code on an employer. If a responsible person willfully fails to collect, pay over, or account for taxes, or otherwise attempts to do defeat the tax, a so-called 100 percent penalty[1104] is assessed. The penalty is an amount equal to the total taxes evaded, not collected, or not accounted for or paid over. It does not include any interest or penalties that the employer may be liable for with respect to the unpaid taxes. Criminal penalties for willful failures may also be incurred.

Self-Employment Contributions Act ("SECA") tax

As a parallel to FICA, SECA tax applies to the net income from self-employment of self-employed individuals, including independent contractors.[1105] The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer portions of the OASDI tax rates under FICA and apply to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self-employment income to which the rate applies.[1106]

Worker classification for employment tax liability

In general

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test under common

[1104] Sec. 6672.

[1105] For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

[1106] Under section 9015 of PPACA, an additional tax of 0.9 percent of self-employment income (parallel to the additional HI portion of the FICA tax) applies to the HI portion of SECA for taxable years beginning after December 31, 2012.

law that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but also as to the circumstances under which it is performed.[1107] However, under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though, applying the common-law test, the facts and circumstances indicate that the worker is properly classified as an employee. This safe harbor applies if the service recipient has a reasonable basis for treating the worker as an independent contractor (including certain specified safe harbors) and certain other requirements are met. In some cases, the treatment of a worker as an employee or independent contractor is specified by statute.

Common-law test

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test that has been incorporated into specific provisions of the Code or that is required to be used pursuant to Treasury regulations or case law. For example, section 3121(d)(2) (which defines terms for purposes of the Social Security taxes that apply to wages paid to an employee) generally defines the term "employee" to include any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. By contrast, section 3401 (which defines terms for purposes of an employer's Federal income tax withholding obligation with respect to wages paid to an employee) does not define the term "employee." However, regulations issued under section 3401 incorporate the common-law test.

The regulations under section 3401 provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[1108] Under the regulations, it is not necessary that the employer actually exercises control over the manner in which the services are performed, rather, it is sufficient that the employer has a right to such control.[1109] Whether the requisite control exists is determined based on all the relevant facts and circumstances.

[1107] Generally the determination of whether a worker is an employee or independent contractor is referred to as worker classification. Because a service recipient is required to withhold income tax and FICA from an employee's wages, and is liable for payment of the employer portion of FICA, during a calendar year, and thus generally must take a position as to the worker's classification before the worker files an income tax return, the first classification of a worker is generally made by the service recipient.

[1108] Treas. Reg. sec. 31.3401(c)-(1)(b).

[1109] *Ibid.* See also, *Gierek v. Commissioner,* 66 T.C.M. 1866 (1993) (involving the classification of a stockbroker and stating that the key inquiry is whether the brokerage firm had a right to control the worker regardless of the extent to which such control was actually exercised). See also, IRS Publication 1779 (Rev. 1-2005).

The origin of the common-law test is the master and servant employment relationship as described in the Restatement (Second) of Agency. Under the Restatement, classification of a worker as a servant (that is, employee) rather than an independent contractor is based on a facts and circumstances determination. The facts are generally evaluated to determine the extent of the service recipient control. The principal difference between a servant and an independent contractor is the extent of control. In the case of a servant, by agreement, the master may exercise control over the details of the work, both with respect to the result the worker is to accomplish and the means by which such result is accomplished.[1110] Over the years, courts have identified on a case-by-case basis various facts or factors that are relevant in determining whether a master-servant (that is, employer-employee) relationship exists.

In 1987, based on an examination of cases and rulings, the IRS developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists.[1111] The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed; factors other than the listed 20 factors may also be relevant.

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test and has grouped illustrative factors under these three categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties.[1112] The IRS emphasizes that factors in addition to the 20 factors identified in 1987 may be relevant, that the weight of the factors may vary based on the

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[1110] Restatement of Agency 2nd , sec. 220 (1958), *Nationwide Mutual Insurance Co. v. Darden,* 503 U.S. 318, and Alden J. Bianchi, "Employee Benefits for the Contingent Workforce," Tax Management Portfolio 399, page A-9.

[1111] Rev. Rul. 87-41, 1987-1 C.B. 296 (providing guidance with respect to section 530 of the Revenue Act of 1978). The 20 factors identified by the IRS are: (1) instructions (compliance with instructions required indicates employee status); (2) training (the provision of training by service recipient indicates employee status): (3) integration (integration of the worker's services into the business operations of service recipient indicates employee status); (4) services must be rendered personally (indication of employee status); (5) hiring, supervision, and paying assistants (if service recipient hires, supervises or pays assistants, it indicates employee status, but if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status); (6) continuing relationship (indicates employee status); (7) set hours of work (indicates employee status); (8) full time services required (indicates employee status); (9) work done on employer's premises (indicates employee status if work could be done elsewhere); (10) order or sequence test (indicates employee status if a worker must perform services in the order or sequence set by service recipient); (11) oral or written reports required (indicates employee status); (12) payment by the hour, week, or month (indicates employee status); (13) payment of business and/or traveling expenses (indicates employee status): (14) furnishing tools and materials by service recipient (indicates employee status); (15) significant investment by worker (indicates independent contractor status); (16) realization of profit or loss by worker (indicates independent contractor status); (17) working for more than one firm at a time (indicates independent contractor status); (18) making services available to the general public (indicates independent contractor status); (19) service recipient has right to discharge (indicates employee status); (20) worker has right to terminate relationship (indicates employee status).

[1112] Department of the Treasury, Internal Revenue Service, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I, at 2-7. This document is publicly available through the IRS website.

circumstances, that relevant factors may change over time, and that all facts must be examined.[1113]

Section 530 of the Revenue Act of 1978

Section 530 of the Revenue Act of 1978 ("section 530") generally allows a taxpayer who is a service recipient to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment or otherwise fails to meet certain requirements. The relief provided to an employer under section 530 was initially a temporary measure (scheduled to terminate at the end of 1979) to give Congress time to resolve the many complex issues regarding worker classification. Section 530 was permanently extended in 1982 and later revised.[1114]

Under section 530, a reasonable basis for treating a worker as an independent contractor is deemed to exist if the taxpayer reasonably relied on: (1) past IRS audit practice with respect to the taxpayer, (2) published rulings, technical advice with respect to the taxpayer, or judicial precedent, or (3) long-standing recognized practice of a significant segment of the industry in which the taxpayer is a member. With respect to the industry practices safe harbor, section 530 specifically provides that the significant segment requirement does not require more than 25 percent of the industry (determined without taking the taxpayer into account). The "long-standing" requirement does not require the practice to have continued for more than 10 years and the practice does not fail to be long standing merely because it began after 1978. In addition, a taxpayer can rely on any "other reasonable basis" for treating a worker as an independent contractor.

The relief under section 530 is available with respect to a worker only if certain additional requirements are satisfied. The taxpayer must not have treated the worker as an employee for any period, and for periods after 1978 all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. Further, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position to the worker as an employee for purposes of employment taxes for any period beginning after 1977 (the "similar worker consistency requirement").

The similar worker consistency requirement does not apply with respect to services performed after December 31, 2006, by an individual who provides services as a test proctor or room supervisor by assisting in the administration of college entrance or placement examinations.[1115] This exception only applies if the service recipient is an organization that is

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[1113] *Ibid.* p. 2-3 through p. 2-7.

[1114] Section 530 was extended through the end of 1980 by Pub. L. No. 96-167 and through June 30, 1982, by Pub. L. No. 96-541. It was permanently extended by the Tax Equity and Fiscal Responsibility Act of 1982. A number of changes to section 530 were made by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, and the Pension Protection Act of 2006.

[1115] Section 864 of the Pension Protection Act of 2006.

described in section 501(c) and the service provider is not otherwise treated as an employee of the organization for employment tax purposes.

Section 530 does not apply in the case of a worker who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[1116] Thus, the determination of whether such workers are employees or independent contractors for purposes of employment taxes is made in accordance with the common-law test.

Section 530 also prohibits Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes.[1117] However, in response to a taxpayer request, the IRS may issue a written determination regarding the status of a particular worker as an employee or independent contractor for purposes of Federal employment taxes and income tax withholding.[1118]

Moreover, section 530 only applies to the service recipient and only applies for purposes of employment taxes. Thus, if a service recipient treats a worker as an independent contractor, the worker is not required to take a consistent position on the worker's tax return if, under the common-law test, the worker is an employee.

Section 530 does not apply for other employee benefit purposes that use the common-law test for determining who is an employee, such as the coverage requirements for qualified retirement plans under section 401(a) and ERISA.

Statutory employees or independent contractors

The Code contains various provisions that prescribe treatment of a specific category or type of worker as an employee or an independent contractor. Some of these provisions apply for Federal tax purposes generally; for example, certain real estate agents and direct sellers are treated for all tax purposes as not being employees.[1119] Others apply only for specific purposes; for example, full-time life insurance salesmen are treated as employees for social security tax

[1116] Section 1706 of the Tax Reform Act of 1986.

[1117] Rev. Rul. 87-41 (described above) provides guidance with respect to section 530 of the Revenue Act of 1978.

[1118] IRS Form SS-8 (Rev. 11-2006). A written determination with regard to prior employment status may be issued by the IRS. The IRS will not issue a written determination with respect to prospective employment status. Rev. Proc. 2007-3, 2007-1 I.R.B. 108.

[1119] Sec. 3508.

and employee benefit purposes,[1120] and certain salesmen are treated as employees for social security tax purposes.[1121]

Worker classification tests under other Federal laws and State laws

Federal labor laws

A worker's status as independent contractor or employee is relevant for a number of Federal labor laws. Generally, employees are protected under these laws but independent contractors are not.[1122] In *Nationwide Mutual Insurance Co. v. Darden*, the Supreme Court held that, under Federal law, the common-law test applies to determine who is an employee where no definition is specified.[1123] However, the Supreme Court in *Nationwide Mutual Insurance Co.* indicated that a different result can be reached when the statue does more than refer to employees. As an example, the Court indicated that the Fair Labor Standards Act ("FLSA") defines the verb "employ" expansively to mean "suffer or permit to work." The Court pointed out that this definition "stretches the meaning of the word 'employee' to cover parties who might not qualify as such under a strict application of traditional agency law principles."[1124] With respect to the FLSA, the Supreme Court has found that the classification of a worker as an employee should not be bound by the limits of the common law of agency but instead should be based on the underlying "economic realities" of the relationship between the worker and the service recipient ("economic realities test").[1125]

ABC test under certain State unemployment laws

Many States apply a standard for State unemployment tax that sweeps in most workers – popularly referred to as the "ABC test" (so called because of its three-pronged approach). While different States have slightly different tests, they generally include the same basic requirements. As an illustration, the Maryland ABC test provides that a worker is not an employee if:

[1120] Sec. 3121(d)(3)(B) and 7701(a)(20).

[1121] Sec. 3121(d)(3)(D).

[1122] G.J. Stillson MacDonnell, "Independent Contractor Status under Federal Labor and Employment Laws," Robert E. Wood, *Legal Guide to Independent Contractor Status, Fourth Ed.*, Tax Institute, San Francisco, CA, 2007, Chapter 5. Examples of these laws are Title VII of the Civil Rights Act of 1964; the Age Discrimination in Employment Act ("ADEA"); the Fair Labor Standards Act ("FLSA"); the National Labor Relations Act ("NLRA"); the Employee Retirement Income Security Act (ERISA); and the Family and Medical Leave Act ("FMLA").

[1123] 503 U.S. 318 (1992).

[1124] *Ibid*. p. 326.

[1125] *Goldberg v. Whitaker House Cooperative,* 366 US 28 (1961) and *Rutherford Food Corp v. McComb*, 331 U.S. 722 (1947).

A. The individual who performs the work is free from control and direction over its performance both in fact and under the contract;

B. The individual customarily is engaged in an independent business or occupation of the same nature as that involved in the work; and

C. The work is (1) outside of the usual course of business of the person for whom the work is performed, or (2) performed outside of any place of business of the person for whom the work is performed.[1126]

Description of Proposal

The proposal generally permits the IRS to require prospective reclassification of workers who are currently misclassified by service recipients but whose reclassification has been prohibited under the present-law section 530 safe harbor.

Treasury and the IRS are also permitted to issue generally applicable guidance on the proper classification of workers under common-law standards, thereby enabling service recipients to properly apply those standards, and minimizing concerns that an IRS examination would produce a different result. In developing any such guidance, Treasury is directed to interpret the common law in a neutral manner recognizing that many workers are, in fact, not employees. Such guidance is to include narrowly defined safe harbors and/or rebuttable presumptions. To make the guidance clearer and more useful for service recipients, a substantial portion of the published guidance is expected to be industry-specific or job-specific. Priority for the development of guidance is to be given to industries and jobs in which application of the common-law test has been particularly problematic, where there has been a history of worker misclassification, or where there have been historical failures to report compensation paid.

Present-law reduced penalties for misclassification are retained, except that lower penalties apply only if the service recipient voluntarily reclassifies its workers before being contacted by the IRS or another enforcement agency and if the service recipient has filed all required information returns (Forms 1099) reporting the payments to the workers. For service recipients with only a small number of employees and a small number of misclassified workers, penalties (including reduced penalties) may be waived if the service recipient (1) consistently filed Forms 1099 reporting all payments to all misclassified workers, and (2) agrees to prospective reclassification of misclassified workers. It is anticipated that, after enactment, new enforcement activity will focus mainly on obtaining the proper worker classification prospectively, since in many cases the proper classification of workers may not have been clear.

[1126] MD Code, Labor and Employment, sec. 8-205 (available at http://www.michie.com/maryland/lpext.dll?f=templates&fn=main-h.htm&2.0). For a further discussion of the ABC test, see Robert E Wood, *Legal Guide to Independent Contractor Status, Fourth Ed*., at 1.09, and Andrew Stettner, Rebecca Smith, and Rick Mc Hugh, *Changing Workforce, Changing Economy*, National Employment Law Project, New York, N.Y. (2004) at 34-35.

Under the proposal, service recipients are required to give notice to independent contractors when they first begin performing services for the service recipient. Such notice must explain how they will be classified and the consequences thereof (e.g., tax implications, workers' compensation implications, and wage and hour implications).

The IRS is permitted to disclose to the Department of Labor information about service recipients whose workers are reclassified.

To ease compliance burdens for independent contractors, independent contractors receiving payments totaling $600 or more in a calendar year from a service recipient are permitted to require the service recipient to withhold, for Federal tax purposes, a flat rate percentage of their gross payments, with the flat rate percentage being selected by the contractor.

Effective date.−The proposal is effective upon enactment, but prospective reclassification of those covered by section 530 is not effective until the first calendar year beginning at least one year after date of enactment. A transition period of up to two years is provided for independent contractors with existing written contracts establishing their status.

Analysis

Common-law test

The proposal permits IRS to require prospective compliance with the common-law test, as interpreted in Treasury guidance, for all taxpayers for purposes of employment taxes, including service recipients entitled to rely on section 530 under present law. Critics of the common-law test point out that a major source of the confusion regarding classification of a worker is that the common-law test requires an examination of a variety of factors that often do not result in a clear answer. Although the proper classification of a worker is clear in many circumstances, in close cases, the law creates a significant gray area that leads to complexity, with the potential for inadvertent errors.[1127] They argue that a more objective standard is needed for worker classification that leaves fewer situations unclear.

Critics of the common-law test argue that the test, when combined with what they characterize as the bias of the IRS toward classification of workers as employees, leaves service recipients vulnerable to being second guessed by IRS agents on audit. However, others argue that the common-law test places too great an emphasis on "control" by service recipients and can be manipulated by them. They argue that a test, such as the ABC test or the economic realities

[1127] Under the common-law test, some factors may support employee status, while others may support independent contractor status. No guidance is provided for how to weigh any particular factor. In addition, some factors involve an examination of objective facts, while others involve an examination of subjective facts or an examination of a combination of objective and subjective facts. Because the determination of proper classification requires weighting the specific facts, reasonable people may differ as to the correct result given a certain set of facts. Thus, for example, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by weighing some of the relevant factors differently than the taxpayer. Similarly, a worker and a service recipient may reach different conclusions as to the proper classification of the worker.

test, that expands the workers that must be classified as employees may be necessary to counter balance the strong incentive for service recipients to treat workers as independent contractors and the lack of bargaining power of workers being misclassified to demand employee treatment.

Adoption of a standard other the common-law test requires a foundation in the relevant statutory language.[1128] Thus, absent statutory language that supports a broader definition of employee, such a change would be difficult for Treasury to undertake through regulations alone.

Published guidance on worker classification

As discussed above, since the enactment of section 530, the Treasury and the IRS have been prohibited from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes. The resulting lack of current guidance contributes to the lack of clarity in the law and increases the likelihood of inadvertent misclassification of workers. Previously issued guidance may not reflect current case law, statutory changes, or changes in workplace situations. Without appropriate guidance, not only are differences between taxpayers and the IRS more likely, but different IRS agents may reach different conclusions on the law as well as the relevant facts, resulting in increased inconsistent enforcement.[1129]

Thus, most would agree that allowing the IRS and Treasury to again issue published guidance of generally applicability, including regulations, is likely to improve worker classification compliance. However, the extent of this improvement depends on the guidance itself. Some argue that the strong bias that they perceive the IRS as having toward classification of workers as employees is likely to be reflected in any published guidance. They argue that this concern was an impetus for the provision in section 530 precluding IRS from issuing published guidance.

The proposal is designed to allay these concerns in a number of ways. First, the proposal specifies that the IRS and Treasury are to develop guidance that is neutral between classification of a worker as an employee or as an independent contractor, thus recognizing that many workers are, in fact, not employees. The guidance is also to include narrowly defined safe harbors or rebuttable presumptions, and a substantial portion of the guidance is to be industry or job

[1128] See *Nationwide Mutual Insurance Co. v. Darden, supra*. However, some courts use a combination of the factors under the common-law test and economic realities test, reasoning that the common law allows all aspects of the working relationship to be considered. This approach generally arises in the context of Title VII cases. See, for example, *Wilde v. County of Kandiyohi*, 13 F. 3d 103(8th Cir. 1994) and *Frankel v. Bally*, 987 F. 2d 86 (2nd Cir. 1993)

[1129] The IRS has made publicly available its training guide for agents on worker classification issues. Department of the Treasury, Internal Revenue Service, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I. The guide may aid consistent enforcement by different agents and provide a guide to taxpayers regarding the state of the law; however, the guidelines leave substantial discretion to individual agents and do not resolve all issues. Further, the guidelines do not carry the same force of law as revenue rulings or regulations.

specific. These guidelines recognize the need to prevent any particular service recipient from having a competitive advantage or disadvantage.

As noted above, some argue that there is a serious question whether it is possible to provide guidance that is simple, clear, and easy to understand in the context of the common-law facts-and-circumstances test. Some argue that guidance that provides very specific lines between employee and independent contractor status also may provide a road map for service recipients to structure the appearance of their relationship with workers as satisfying the standard in the guidance for classification of the worker as an independent contractor. This may occur even though, based on the actual facts and circumstances, the relationship is best characterized as that of an employee and employer.

Retention of a safe harbor for reasonable determinations by service recipient

Supporters of section 530 argue that a safe harbor is needed which continues to protect a service recipient's reasonable classification of workers as independent contractors in order to give businesses some certainty that their classifications will not be second guessed by the IRS. Supporters argue that retention of the current safe harbor for industry practice is needed to allow businesses within the same industry to classify workers and make legal arrangements in a manner consistent with their competitors. They argue that being permitted to follow industry practice prevents a business from being forced to choose between following the industry practice, or making an independent judgment and being put at a competitive disadvantage.

Opponents of section 530 point out that, although section 530 was intended to reduce disputes between the IRS and taxpayers regarding classification issues, it has itself been a source of disputes. Like the common-law test, some aspects of section 530 depend on the facts and circumstances and reasonable people may differ as to the correct result given a certain set of facts, i.e., whether section 530 properly is available to the taxpayer. Those in favor of curtailing section 530 relief also point out that following industry practice is not a recognized legal standard for interpreting the law, and therefore should not be a reasonable basis for a legal determination. They argue that allowing use of industry practice as a defense or safe harbor simply encourages entire industries to continue to misclassify workers.[1130] They further argue that the industry practice safe harbor puts employers who chose not to rely on the safe harbor at a competitive disadvantage. Eliminating the industry-practice safe harbor would require service recipients to make the determination as to worker classification under the same legal standards as apply for other legal determinations under common law. A separate issue may be whether a reasonable determination that a worker is an independent contractor based on the application of recognized legal standards, such as judicial precedents, should be retained as a safe harbor.

[1130] Marc Linder, "Employed or Self-employed? The Role and Content of the Legal Distinction: Dependent and Independent Contractors in Recent U.S. Labor Law: an Ambiguous Dichotomy Rooted in Simulated Statutory Purposelessness," 21 *Comparative Labor Law and Policy Journal* 187, Fall 1999, at 214 (characterizing the industry practice safe harbor as facilitating "the very race to the bottom that compulsory labor-protective laws are designed to thwart").

Another criticism of section 530 is that it applies only to the service recipient and only for employment tax purposes. As a result of these limitations, if a worker is treated by the service recipient as an independent contractor under section 530, the worker may mistakenly believe he or she is in fact an independent contractor for Federal income tax purposes. However, because section 530 does not apply for Federal income tax purposes, the worker is still required to determine whether he or she is an independent contractor or employee under the common-law test without regard to section 530.

Proponents of curtailing section 530 relief argue that elimination of the safe harbor allows consistent classification by the worker and the service recipient. It would also eliminate a major barrier for workers to obtain the protection of being classified as an employee under other areas of law, both under the Code and other Federal and State laws, such as unemployment insurance and worker's compensation. Although section 530 is only a safe harbor for employment taxes, employers generally classify workers in the same manner for all purposes. Proponents of curtailing section 530 relief argue that, if an employee is classified as an independent contractor for employment tax purposes and section 530 protects the service recipient from reclassification of the worker for employment taxes, it is difficult for the IRS, other Federal agencies, and employees to challenge classifications for purposes outside the context of employment taxes.[1131] A worker may not understand that he or she is an employee for purposes of other Federal law, such as the FLSA, or may feel powerless to assert such right.[1132]

Prospective versus retroactive application of reclassification determinations

In general

The proposal provides a transition period for service recipients eligible to rely on section 530 under present law to voluntarily reclassify workers by specifying that prospective reclassification is not required until the first calendar year beginning at least one year after date of enactment. Some point out that the common-law test is a subjective facts and circumstances standard, and then argue that, if the employer has a reasonable basis for concluding that workers are independent contractors, any liability resulting from a different determination by the IRS should only be prospective. They argue that this was the original reason for the enactment of section 530, to prevent the IRS from second guessing an employer and imposing penalties for the past. Others argue that this just encourages employers to "hide in the weeds" and hope that they are not identified through an audit. They point out that the economic benefit to businesses to take this position creates a significant motivation for a business to misclassify employees as independent contractors. Further, as time goes on, a business may develop a vested interest in

[1131] For example, even though a service recipient's classification of a worker as an independent contractor may be protected under section 530 for purposes of employment taxes, that classification may not be correct for other tax purposes, such as liability for failure to offer health coverage to full-time employees under section 4980H, added by section 1513 of PPACA (effective for calendar years beginning after December 31, 2013).

[1132] Catherine K. Ruckelhaus, "Labor's Wage War," 35 *Fordham Law Journal* 373, footnote 63 (pointing out that fear of reprisal prevents complaints with respect to wage and hour law violations despite the FLSA prohibition against such reprisal).

retaining this characterization and may be less willing to concede to an IRS determination that the worker is an employee on audit.

Others contend that an appropriate compromise is to require prospective reclassification independent of a specific IRS determination that the workers in a business are employees, only after the IRS issues industry-specific guidance that applies to the employees of the business. This reduces the possibility of businesses that reclassify workers as employees being at a competitive disadvantage.

Some argue that, even after guidance is issued, employers who comply based on a reasonable interpretation of the guidance, or some higher standard such that the taxpayer's interpretation is more likely than not to be correct, should be protected against retroactive reclassification of their workers to the extent that the guidance leaves room for different interpretations of a set of facts and circumstances. Others argue that this approach encourages businesses to interpret the guidance with a bias toward allowing a worker to be classified as an independent contractor even when the business recognizes that the interpretation is not intended, and the taxpayer expects the IRS to reach a different conclusion. This makes any retroactive assessment on audit the equivalent of a penalty against which the taxpayer can make a "good cause" argument rather than a tax for which the taxpayer is liable. One response to those making this argument would be to allow a reduction in liability and penalties, such as under present-law section 3509, but not completely relieve the taxpayer of retroactive liability.

Waiver of penalties for certain service recipients with a small number of workers

Under the proposal, for service recipients with only a small number of employees and a small number of misclassified workers, even reduced penalties are permitted to be waived if the service recipient consistently filed Forms 1099 reporting all payments to all misclassified workers, and agreed to prospective reclassification of misclassified workers. Assuming that waiver of the penalties means waiver of retroactive liability, this is equivalent to applying reclassification only prospectively. Proponents of prospective-only reclassification argue that there is no reason to limit this relief to service recipients with a small number of workers. For the reasons discussed above, they argue that all service recipients need this relief.

Supporters of this special rule argue that small businesses are the least sophisticated service recipients and are unlikely to be able to obtain legal counsel for worker classification issues. Thus, they argue that the focus for this group should be to obtain prospective proper classification. Some may respond that a better approach would be for IRS to undertake special outreach to educate this group but that taxpayers should not be rewarded for noncompliance with the law.

Contracts specifying worker classification

In some cases, a worker and service recipient mutually agree to the classification of the worker as an independent contractor, either informally or in a written contract. They may mutually prefer to have the worker classified as an independent contractor, for tax and nontax reasons.[1133] For example, the worker may wish to take advantage of the ability to contribute on a deductible basis to a pension plan or to deduct significant work-related expenses. Workers may prefer independent contractor status because it gives them more control over their livelihood. To the extent workers express this preference, the service recipients may feel compelled to classify a worker as an independent contractor to retain the worker. On the other hand, a service recipient may wish to avoid administrative issues associated with withholding income and employment taxes, as well as liability under other Federal law. The payments agreed to between the parties may be negotiated to reflect the difference in responsibilities between classification as an employee or as an independent contractor.

Some argue that if the worker and service recipient contractually agree as to the classification and both act consistently with the contract, such contractually-agreed-to treatment should be given deference in any classification determination, particularly when the proper classification is not clear.[1134] They argue that, as long as either the worker pays SECA and income taxes, or the employer pays FICA and income tax withholding, the IRS should be indifferent as to the classification. Proponents of this approach argue that problems arise when the worker and the service recipient are taking inconsistent positions so neither is paying the appropriate social security taxes. They argue that absent a legal right to such deference, the IRS may feel compelled to use its power to make an independent determination of the facts and circumstances, and apply retroactive liability and penalties if it reaches a different conclusion as to the proper classification. Arguably, because the determination is based on the facts and circumstances many of which require a subjective determination, an independent determination may not be any more reliable than the agreed-to classification. The proposal gives some recognition to this argument by providing a two-year transition period for existing contracts.

Others contend that contracts between the parties specifying how the worker is to be classified are irrelevant, and the actual behavior of the parties is the only relevant consideration. Tax receipts and the total combined tax liability of the worker and service recipient are not the same regardless of the classification. They argue that, even if the ultimate combined tax liability of the parties is not significantly affected by the classification, the IRS has an interest in classifying workers as employees whenever appropriate, to obtain the compliance benefits of mandatory withholding.[1135] The parties should not be able to contract away that obligation of the employer.

[1133] Kirsten Harrington, "Employment Taxes: What Can the Small Businessman Do?" 10 *Akron Tax Journal*, 61 (1993).

[1134] Even if contracts were given some deference in worker classification determinations, an important first step would be an examination of the contract to determine if it in fact describes a relationship that is consistent with a worker being classified as an independent contractor and the agreement is in fact mutual. Those arguing in favor of giving deference to contracts generally presuppose that the worker freely agrees to the classification and the worker and service recipient have equal bargaining power. Some argue that service recipients frequently simply apply this classification without any clear basis for such treatment or opportunity for objection by the worker.

[1135] Mark Berger, "Rethinking the Legal Oversight of Benefits Program Exclusions," 33 *Rutgers Law Journal*, 227, 240, Winter, 2002.

Further, opponents of giving deference to contracts argue that the bargaining power, and sophistication, of the parties is not equal in many, if not most, circumstances. They argue that, in many cases, workers may feel they have little choice but to agree to their classification as independent contractors. In reality, the agreement may not be mutual. Even if a worker freely agrees to the classification, these opponents point out that a service recipient is likely to have a better understanding of its economic reasons for wanting to misclassify workers as independent contractors than a worker has of the economic benefits of being classified as an employee or the cost of being classified as an independent contractor. Workers may lack the sophistication to fully understand the implications of being classified as an independent contractor and how much larger payments need to be to reflect the increased costs and potential liabilities from being an independent contractor rather than an employee.[1136] For example, in addition to avoiding employment tax responsibilities, the service recipient may wish to avoid coverage and nondiscrimination requirements applicable to qualified retirement plans by classifying lower-paid workers as independent contractors. The service recipient may want to avoid liability for workmen's compensation and may want to prevent the workers from having a right to join a labor union. A worker may not be aware of these economic advantages to the service recipient or fully appreciate their implications until an event occurs that makes the worker aware of the rights lost, such as a workplace injury.

<u>Consistent classification of workers for all purposes</u>

As under present law, the proposal only applies for purposes of employment taxes and by implication for purposes of the Code. As indicated above, worker classification is relevant for purposes of numerous Federal laws and for State law purposes.

Some argue that the same definition of employee should apply for purposes of Federal tax law and Federal labor laws.[1137] As long as treatment under a law is dependent on an individual's status as an "employee," absent a consistent definition, workers are unlikely to be able to independently determine their status for each purpose in order to demand the protection accorded them under Federal labor laws. Proponents of consistent classification argue that workers are most likely to be aware of their status for purposes of employment taxes. They know whether payroll taxes are being withheld from their paycheck or not. Thus, proponents of a single definition of employee for Federal law argue that the IRS is in the best position to administer and enforce proper worker classification. They argue that Federal agencies should be required to coordinate their interpretations of the law and enforcement with IRS.

[1136] Todd D. Saveland, "Note: FedEx's New 'Employees': Their Disgruntled Independent Contractors," 36 *Transportation Law Journal* 95, Spring, 2009. The author points out that the contractual relationship starts out seeming like a win-win for both the worker and the service recipient but then when the parties do not live happily ever after, the worker files suit.

[1137] Sharon Dietrich, Maurice Emsellem, and Catherine Ruckelshaus, "Work Reform: The other Side of Welfare Reform: Our policymakers must face the reality that failures of employment law policies are a major reason for welfare recipiency," 9 *Stanford Law and Policy Review* 53, 60, Winter, 1998.

Others argue that there should not be one definition of employee but rather the definition should vary depending on the purpose for which the definition is being used under the law.[1138] They argue that definition should be customized to the specific purpose for which it is being used.

Alternatively, some argue that some rights should not be conditioned on classification as an employee.[1139] All workers of a particular type in a particular industry should have certain fundamental protections and rights, determined without regard to the worker's classification as employee or independent contractor. Others argue that a service recipient should have only limited responsibility for workers not under its control or for workers that the employer does not have even the right to control.

<u>Worker classification and the contingent work force</u>

The Bureau of Labor Statistics ("BLS") provides the following description of contingent and alternative employment arrangements:

"Contingent workers are persons who do not expect their jobs to last or who reported that their jobs are temporary. They do not have an implicit or explicit contract for ongoing employment. Alternative employment arrangements include persons employed as independent contractors, on-call workers, temporary help agency workers, and workers provided by contract firms."[1140]

Treasury indicates that a substantial portion of its guidance will be industry specific. There is no indication that Treasury views any special rules or attention as needed for the contingent workforce, separate from a particular industry or job in which they are utilized.

Some argue that contingent workers have become second-class employees. Generally, their arrangement includes some characteristics suggesting independent contractor status, such as a short-term relationship and less than full time schedule or irregular hours. Businesses create jobs for contingent workers with the objective of providing different compensation packages and working conditions for these workers. They argue that this second-class status puts contingent workers in a weaker position to oppose misclassification. They also argue that contingent workers are likely to be workers with few other employment opportunities. They point out that

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[1138] Marc Linder, "Employed or self-employed? The Role and Content of the Legal Distinction: Dependent and Independent Contractors in Recent U.S. Labor Law: an Ambiguous Dichotomy Rooted in Simulated Statutory Purposelessness," 21 *Comparative Labor Law and Policy Journal* 187, Fall 1999.

[1139] Some circuits of the Court of Appeals have interpreted Title VII of the Civil Rights Act as protecting independent contractors (without regard to any reclassification as an employee) in certain circumstances. See for example, *Gomez v. Alexian Brothers Hospital*, 698 F. 2d 1019 (9th Cir. 1983), and *Doe v. St Joseph's Hospital*, 788 F. 2d 411 (7th Cir. 1986). See also G.J. Stillson MacDonnell, "Independent Contractor Status under Federal Labor and Employment Laws," at 5.02[B] (discussing Court of Appeals cases that recognize Title VII as protecting employment opportunities of independent contractors and those cases that limit Title VII protection to employees).

[1140] Available at: http://www.bls.gov/cps/lfcharacteristics.htm#contingent.

vulnerable employees, wrongly classified as independent contractors, may be unwilling to complain for fear of retaliation by their employer (regardless of the protection Federal law may accord the employee against such reprisal).

Some argue that an employer may be willing to give up control (or at least the semblance of control) to gain the advantage of treating contingent workers as independent contractors, and that employers may specifically design these jobs to avoid the appearance of having the requisite control to compel a classification of employee. Because the determination of employee status is inherently factual and includes subjective determinations, employers may be able to structure the arrangement with contingent workers so that it is more difficult to argue that a classification of a contingent worker as an independent contractor is improper. As noted above, there are strong financial incentives for an employer to classify workers as independent contractors whenever possible. They argue that the service recipients of contingent workers should be subject to greater scrutiny than service recipients of other independent contractors. They argue that Treasury should direct specific guidance toward the contingent work force as a special group apart from any specific industry in which they are performing services.

Others argue that contingent workers are no more vulnerable than other workers. They argue that many workers choose to be contingent workers and that the workers actually prefer their alternative work arrangements, including their status as independent contractors, to traditional jobs.[1141] They argue that there should not be a bias in the law against classifying a worker as an independent contractor in an appropriately structured business relationship between the worker and service recipient. Thus, they would argue that the contingent work force should not be a specific target for published guidance.

Special rules in the proposal

Reduced penalties under section 3509

Under the proposal, current law relief under section 3509 would be limited to situations where a service recipient voluntarily reclassifies its workers before being contacted by the IRS. The relief under section 3509 is arguably unrelated to the curtailment of section 530 relief. Under present law, section 3509 only applies to a taxpayer that does not qualify for section 530 relief. Thus, even proponents of the curtailment of section 530 relief may argue that this

[1141] Marisa DiNatale, "Characteristics of preferences for alternative work arrangements, 1999" Monthly Labor Review March 2001, 28. The article describes the results of BLS 1999 Contingent and Alternative Work Arrangement Survey in which it found that one third of independent contractors in this category held a college degree and 12 percent held an advanced degree. The article points out that these proportions are slightly lower for traditional workers for the same time period which the article indicates is 31 percent college graduates and for which 10 percent held advanced degrees. The article also points out that compared with traditional workers, independent contractors at that time were more likely to be men, older, and white. The article indicates that, at least in 1999, the overwhelming majority of independent contractors were very happy in their arrangement and entered it voluntarily. Under the survey, about 84 percent of independent contractors reported that they preferred their arrangement to a traditional one in February 1999. A BLS News Release (USDL 05-1433), "Contingent and Alternative Employment Arrangements, February 2005," dated July 27, 2005, reports similar conclusions with respect to independent contractors in 2005.

proposed limitation on present law relief under section 3509 is beyond the scope of such a change. Critics of the curtailing section 530 relief argue that limiting the scope of section 3509 in conjunction with prospective curtailment of section 530 relief is likely to exacerbate the difficulties of this change. They argue that limiting the relief under section 3509 to those who have voluntary reclassified provides the relief to the wrong group. Those who have reclassified voluntarily presumably know that their classification was incorrect. Section 3509 is designed for taxpayers who are not entitled to protection under section 530 and unintentionally misclassify one or more employees as independent contractors.

Others argue that the reduced penalties under section 3509 are related to the relief under section 530. They argue that both provisions reduce compliance with proper worker classification. To the extent the risks from misclassification are reduced, service recipients feel comfortable erring on the side of classifying an employee as an independent contractor or at least "skating right up to the line" if the liability for misclassifying a worker as an independent contractor is reduced. They argue that the compliance structure should encourage service recipients to err on the side of classifying workers as employees. To the extent that there is any relief for misclassification, it should be for service recipients and workers when workers are misclassified as employees rather than as independent contractors.

Requiring service recipients to withhold income taxes upon request by independent contractors.

Under the proposal, independent contractors receiving payments totaling $600 or more in a calendar year from a service recipient are permitted to require that the service recipient withhold for Federal tax purposes at a flat rate percentage of their gross payments, with the flat rate percentage selected by the contractor. Essentially, this proposal converts section 3402(p)(3) which, under present law, grants authority to the Secretary to provide for income tax withholding when both parties agree, into a provision that requires a service recipient to withhold income tax upon request by an independent contractor. The proposal does not require withholding in the amount requested by the independent contractor but instead at the rate chosen by the service recipient. It is unclear whether this applies only to an independent contractor who works fulltime for a single service recipient and only if the relationship is for an extended period, or whether any independent contractor can make this request for any payment and the service recipient is compelled to comply. Some argue that this mandated withholding is inconsistent with a legitimate service recipient and independent contractor relationship. They argue that inherent in that relationship is that the independent contractor is responsible for paying his or her own estimated taxes. They argue that a taxpayer sophisticated enough to request income tax withholding is sophisticated enough to make estimated tax payments.

Prior Action

No prior action.

10. Codify economic substance doctrine

A provision similar to the President's fiscal year 2011 budget proposal was enacted in the Health Care and Education Reconciliation Act of 2010.[1142]

The Presidents fiscal year 2011 budget proposal was identical to the President's fiscal year 2010 budget proposal.[1143]

11. Allow assessment of criminal restitution as tax

A provision substantially similar to the President's fiscal year 2011 budget proposal was included in the Firearms Excise Tax Improvement Act of 2010.[1144]

12. Revise offer-in-compromise application rules

Present Law

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise.[1145] Treasury regulations provide that such offers can be accepted: (1) if there is doubt as to the validity of the actual tax liability, (2) if it is doubtful that the tax, interest, and penalties can be collected, or (3) to promote effective tax administration in a case where collection in full would cause the taxpayer economic hardship.[1146] Compromises with respect to unpaid tax liabilities of $50,000 or more can be accepted only if the reasons for the acceptance are documented in detail and supported by a written opinion from the IRS Chief Counsel.[1147] The $50,000 threshold was raised from $500 in 1996.[1148]

The Tax Increase Prevention Reconciliation Act of 2005 ("TIPRA") included a provision requiring taxpayers to make certain nonrefundable payments with any initial offer-in-

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[1142] Pub. L. No. 111-152, sec. 1409. The enacted provision is described in Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act,"* (JCX 18-10) March 21, 2010, at pp. 142-156.

[1143] The President's Fiscal Year 2010 Budget Proposal is discussed in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Two: Business Tax Provisions* (JCS 3-09) September, 2009 at pp. 34-71.

[1144] Section 3 of H.R. 5552 passed June 29, 2010 by the House of Representatives, and passed by unanimous consent by the Senate on August 6, 2010. As of the time of publication, it is expected the Firearms Excise Tax Improvement Act of 2010 will be signed into law by the President.

[1145] Sec. 7122.

[1146] Treas. Reg. sec. 1.7122-1(b). For this purpose, economic hardship is defined under Treas. Reg. sec. 301.6343-1.

[1147] Treas. Reg. sec. 1.7122-1(e)(6).

[1148] Sec. 503 of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168.

compromise of a tax case.[1149] This provision requires taxpayers making a lump sum offer-in-compromise to include a nonrefundable payment of 20 percent of the lump-sum with the initial offer.[1150] In the case of an offer-in-compromise involving periodic payments, the initial offer must be accompanied by a nonrefundable payment of the first installment that would be due if the offer were accepted.[1151]

Description of Proposal

The proposal eliminates the requirement that an initial offer-in-compromise include a nonrefundable payment of any portion of the taxpayer's offer.

Effective date.−The proposal is effective for offers-in-compromise submitted after the date of enactment.

Analysis

When enactment of the down payment requirement was under consideration in 2006, some predicted that requiring nonrefundable payments with an offer-in-compromise would substantially reduce access to the offer-in-compromise program.[1152] According to those who support the Administration proposal, those predictions have come true. The offer-in-compromise program is designed to settle cases in which taxpayers have demonstrated an inability to pay the full amount of a tax liability. The program allows the IRS to collect the portion of a tax liability that the taxpayer has the ability to pay. Reducing access to the offer-in-compromise program makes it more difficult and costly to obtain the collectable portion of existing tax liabilities.

In her annual report to Congress for 2008, the National Taxpayer Advocate ("NTA") opined that a recent drop in the number of applications for offer-in-compromise relief could be attributable to the required down payment at the time of application, noting that, "The most common source of offers funds is family and friends. It is unlikely that these third parties will provide funds for an offer since they are likely to forfeit 20 percent of the offered amount

[1149] Sec. 509(a) of TIPRA, Pub. L. No. 109-222.

[1150] Sec. 7122(c)(1)(A).

[1151] Sec. 7122(c)(1)(B).

[1152] See, e.g., Dennis B. Drapkin, Testimony on behalf of the ABA before the Subcommittee on Oversight, House Committee on Ways and Means, U.S. House of Representatives, April 6, 2006, available at http://www.abanet.org/tax/pubpolicy/2006/060406testimony.pdf, noting that "A successful offer-in-compromise program raises revenue both from the offer and by bringing taxpayers back into the system. Relatives and employers of the taxpayer are often the source of funds for offers in the current system. These parties will understandably be far less willing to commit nonrefundable monies under the regime that would be created by the Senate bill. Because the 20-percent nonrefundable down payment requirement could dramatically reduce available outside funding for potential offers, there is a significant risk that the proposal could decrease the number of legitimate offers submitted, the number of offers accepted and the number of individuals reentering the tax system. The provision also marks a change in direction from the 1998 Taxpayer Bill of Rights."

without compromising the liability."[1153] That opinion is based on an informal study of case files for 414 offers-in-compromise accepted by the IRS in the months prior to the TIPRA effective date. NTA staff reviewed the closed case files to determine whether the taxpayer could have made a down payment of the amount required by TIPRA on the actual offer submitted and accepted by IRS had that requirement been in effect, and to determine the source of funds used to make the payments required under the terms of the compromise accepted.[1154] Based on the information from the case files, NTA concluded that adequate funds for a down payment would not have been available from the liquid assets (cash, bank accounts, CDs, stock and securities) in 70 percent of the cases. NTA further noted that family and friends were the source of the funds for 232, or 56 percent, of the offers.

There may, however, be alternative explanations for the decline in the number of offers submitted. The number of offers was declining prior to TIPRA, so it would appear that other factors are contributing to the decline. From information in the IRS Data Book, it appears that offers decreased from FY 1997 through FY 1999, increased from FY 1999 through FY 2003, and have declined since then.[1155] One explanation for the decline in offers is that the substantial increase in personal wealth during FY 2004 through FY 2008 resulting from increased housing values, stock portfolios, and retirement plan investments impacted the number of taxpayers meeting the offer-in-compromise requirements. The annual decline in the number of offers was smaller between FY 2007 and FY 2008 (a total decline of 2,000--from 46,000 in FY 2007 to 44,000 in FY 2008) than in the prior years.[1156]

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.[1157]

[1153] 2007 NTA report at Volume 2, section 3, "Effect of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program." The NTA has renewed her call for repeal in her annual legislative recommendations for 2010. 2009 NTA Report to Congress, Volume 1, pages 203-204.

[1154] See, Nina E. Olson, National Taxpayer Advocate, Written Statement of Testimony before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Hearing on Tax Compliance Challenges Facing Financially Struggling Taxpayers, February 26, 2009, available at http://waysandmeans.house.gov/media/pdf/111/olson.pdf.

[1155] Internal Revenue Service Data Book 2008, available at http://www.irs.gov/pub/irs-soi/08databk.pdf.

[1156] *Ibid*.

[1157] H.R. 2343, *The Tax Compromise Improvement Act of 2009*, was introduced in the House of Representatives on May 12, 2009. This bill would eliminate the requirement for taxpayers to pay a percentage of the proposed offer-in-compromise as a mandatory, nonrefundable part of their application.

13. Allow Internal Revenue Service expanded access to information in the National Directory of New Hires

Present Law

The Office of Child Support Enforcement of the Department of Health and Human Services ("HHS") maintains the National Directory of New Hires ("the Directory"), which is a database that contains newly-hired employee data from Form W-4, quarterly wage data from State and Federal employment security agencies, and unemployment benefit data from State unemployment insurance agencies. The Directory was created to help State child support enforcement agencies enforce obligations of parents across State lines.

Under current provisions of the Social Security Act, the IRS may obtain data from the Directory only for the purpose of administering the earned income tax credit ("EITC") and verifying a taxpayer's employment that is reported on a tax return.[1158] The IRS may also negotiate for access to employment data directly from State agencies responsible for such data, to the extent permitted by the laws of the various states. Generally, the IRS obtains such employment data less frequently than quarterly. There are significant internal costs associated with preparing these data for use.

Description of Proposal

The Social Security Act would be amended to expand IRS access to the Directory data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for noncompliant taxpayers, and identification of levy sources. Data obtained by the IRS from the Directory would be protected by existing taxpayer privacy law, including civil and criminal sanctions.

Effective date.–The proposal is effective upon enactment.

Analysis

The proposal could enhance tax administration by providing the IRS with a more efficient method to obtain taxpayer data. Obtaining taxpayer data from the Directory rather than from separate State agencies should increase the productivity of the IRS by reducing the amount of IRS resources dedicated to obtaining and processing such data. Some may argue that allowing the IRS to access the Directory for general tax administration purposes infringes on individual privacy and extends the use of the database beyond its original purpose of enabling State child support enforcement agencies to be more effective in locating noncustodial parents. On the other hand, data obtained by the IRS from the Directory is protected by existing disclosure law. Thus, proponents would argue, the proposal does not reduce the current levels of taxpayer privacy.

[1158] Sec. 32(a)(1).

Prior Action

An identical proposal was included in the President's fiscal year 2006, 2007, 2008, 2009 and 2010 budget proposals.

14. Make repeated willful failure to file a tax return a felony

Present Law

Under present law, the willful failure to file a return, pay taxes, keep records, or supply any information required by the Code is a misdemeanor punishable by a term of imprisonment of not more than one year, a fine up to $100,000, or both.[1159] In the case of a corporation, the monetary penalty is increased to a maximum of $200,000. A taxpayer who fails to file returns for multiple years commits a separate misdemeanor offense for each year. The elements of a willful failure to file require that the government prove beyond a reasonable doubt that (1) the defendant was a person required to file a return; (2) the defendant failed to file at the time required by law, and (3) the failure was willful. The government need not prove that there is an unpaid tax, only that the taxpayer had sufficient income to be required to file a return.[1160]

In contrast, willful tax evasion is a felony, punishable by a prison sentence of up to five years and a fine of up to $250,000 for an individual ($500,000 in the case of a corporation).[1161] Conviction of tax evasion requires that the government prove beyond a reasonable doubt that an affirmative act constituting an attempt to evade or defeat a tax or the payment thereof occurred,[1162] that there is an additional tax due and owing,[1163] and willfulness.[1164]

The punishment of willful tax evasion as a felony rather than a misdemeanor carries with it collateral consequences, in that a person convicted of a felony is deprived of a number of civil and social rights in most States and under Federal law.[1165] Federal immigration law generally

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[1159] Sec. 7203 refers to a maximum fine against an individual of only $25,000 and $100,000 against an organization, the authority of district courts to impose criminal fines is provided in Title 18 of the United States Code, which authorizes a fine of up to $100,000 against an individual convicted of a class A misdemeanor, and $200,000 for an organization convicted of same. 18 U.S.C. secs. 3551 and 3571.

[1160] *Spies v. United States*, 317 U.S. 492, 496 (1943).

[1161] Sec. 7201 refers to a fine against an individual of only $100,000. Title 18 authorizes a Federal court to impose a fine of up to $250,000 against an individual. 18 U.S.C. secs. 3551, 3571.

[1162] *Sansone v. United States*, 380 U.S. 343, 351 (1965); *Spies v. United States*, 317 U.S. 492, 497-99 (1943).

[1163] *Boulware v. United States*, 522 U.S. 421 (2008); *Sansone v. United States*, 380 U.S. 343, 351 (1965).

[1164] *Cheek v. United States*, 498 U.S. 192, 193 (1991).

[1165] 21 U.S.C. sec. 862(a)(1)(A), (B) (1999) denies certain benefits to those convicted of drug offenses.

requires deportation of aliens who are convicted of felonies.[1166] Many States bar felons from voting, owning firearms, and securing a professional license.[1167]

Description of Proposal

Under the proposal, any person who willfully fails to file tax returns in any three years within any five consecutive year period, if the aggregated tax liability for such period is at least $50,000, is subject to a new aggravated failure to file criminal penalty. The proposal classifies such failure as a felony and, upon conviction, imposes a fine of not more than $250,000 ($500,000 in the case of a corporation) or imprisonment for not more than five years, or both.

Effective date.−The proposal is effective for returns required to be filed after December 31, 2010.

Analysis

Some argue that existing criminal tax penalties do not adequately deter criminal behavior, which results in increased noncompliance. Generally, anything that increases the expected costs of noncompliant behavior, such as increased penalties or increased audit rates, would be expected to decrease the amount of noncompliance. Increasing the monetary penalties for failing to file a tax return increases the economic risk of such failure, assuming the likelihood of detection does not decrease.

Similarly, classifying certain willful failure to file cases as felonies should discourage criminal tax violations by substantially increasing the monetary and sentencing consequences of the offense together with the long-term repercussions associated with a felony record. Proponents contend that the filing obligation is of paramount importance to the tax system. They argue that a repeated pattern of intentionally failing to file poses a serious threat to the system and warrants the creation of a separate felony crime.

However, opponents argue that the proposal unnecessarily increases complexity because present law provides enhanced criminal penalties where a failure to file a tax return is accompanied by egregious behavior, such as an intent to evade taxes. In addition, the fact that there are long-term repercussions associated with a felony may have unintended consequences. For example, the government may exercise its discretion to assert such a penalty in fewer cases than if the offense were classified as a misdemeanor. To the extent a penalty is not applied in practice or believed not to be applied in practice, the deterrent effects of the penalty would not be realized. Finally, to the extent the imposition of a criminal penalty may result in significant jail time, the government also must consider the costs of incarceration.

[1166] 8 U.S.C. sec. 1227(a)(2). See also, 8 U.S.C. sec. 1101(a)(43)(M)(ii).

[1167] See e.g., N.Y. Elec. Law sec. 5-106(2), Wyo. Stat. 6-8-102, and ARS sec. 32-741(A) (Arizona).

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009 and 2010 budget proposals.

15. Facilitate tax compliance with local jurisdictions

Present Law

Generally, tax returns and return information ("tax information") are confidential and may not be disclosed unless authorized in the Code. One exception to the general rule of confidentiality is the disclosure of tax information to the States.

Tax information with respect to certain taxes is open to inspection by State agencies, bodies, commissions, or its legal representatives, charged under the laws of the State with tax administration responsibilities.[1168] Such inspection is permitted only to the extent necessary for State tax administration proposes. The Code requires a written request from the head of the agency, body or commission as a prerequisite for disclosure. State officials who receive this information may redisclose it to the agency's contractors but only for State tax administration purposes.[1169]

For purposes of authorizing disclosure of tax information, the term "State" includes the 50 States, the District of Columbia, and certain territories.[1170] In addition, cities with populations in excess of 250,000 that impose a tax on income or wages and with which the IRS has entered into an agreement regarding disclosure also are treated as States.[1171] Indian tribal governments are separately defined as the governing bodies of any tribe, band, community, village or group of Indians, and in certain instances, Alaska Natives, that exercise governmental functions as determined by the Secretary in consultation with the Secretary of Interior.[1172] They are not currently within the scope of those authorized to receive tax information as State or local authorities. However, Indian tribal governments are already treated as States by the tax law for several purposes, such as certain charitable contributions, excise tax credits, and local tax deductions, but not for purposes of information sharing.[1173]

[1168] Sec. 6103(d)(1).

[1169] Sec. 6103(n).

[1170] Sec. 6103(b)(5)(A). In contrast, the term State is generally defined by section 7701(a)(10) to include only the states and the District of Columbia. Neither definition includes Indian tribal governments.

[1171] Sec. 6103(b)(5)(B).

[1172] Sec. 7701(a)(40).

[1173] Sec. 7871.

Description of Proposal

Under the proposal, Indian tribal governments that impose alcohol, tobacco, or fuel excise or income or wage taxes are treated as States for purposes of information sharing to the extent necessary for Indian tribal government tax administration. The proposal requires an Indian tribal government that receives Federal tax information to safeguard it according to prescribed protocols. The proposal imposes criminal and civil sanctions.

Effective date.–The proposal is effective for disclosures made after the date of enactment.

Analysis

Many States use Federal tax concepts as the starting point for their own returns. As a result, those States are dependent on Federal tax information to ensure compliance with their own State tax system. In addition, cooperation between the IRS and State governments is thought to improve voluntary compliance. The IRS has recently embarked on a program to obtain more information from the States to assist with Federal tax compliance.

The proposal expands the definition of State to include an Indian tribal government for purposes of disclosing tax information. Proponents of the proposal may argue that providing tax information to an Indian tribal government may assist such tribe with the enforcement of tribal tax laws. The sharing of information with Indian tribal governments also may encourage the tribes to share information with the IRS that may be helpful for Federal enforcement efforts.

Unlike the rule for cities to be treated as a State, generally requiring a population of 250,000 or more, the proposal sets no minimum population requirement for an Indian tribe to be treated as a State. Thus, some may argue that the privacy rights of taxpayers are more likely to be compromised if the population of taxpayers whose information is subject to disclosure is very small. One also could argue that the benefit to Federal tax compliance would decline as the size of the population diminishes. In addition, Federal tax data is subject to stringent physical and computer security restrictions, which may be costly and burdensome for a small tribal government to implement.

Prior Action

A similar proposal was included in the President's budget proposals for fiscal years 2009 and 2010.

16. Extension of statute of limitations where state tax adjustment affects Federal tax liability

Present Law

In general, the Code requires that taxes be assessed within three years[1174] after the date a return is filed.[1175] If an assessment is not made within the required time periods, the tax

[1174] Sec. 6501(a).

generally cannot be assessed or collected at any future time. The statute of limitations with respect to claims for refund generally expires three years from the time the return was filed or two years from the time the tax was paid, whichever is later.[1176]

Several important exceptions in the Code extend the statute of limitations. If there has been a substantial omission of items of gross income that totals more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[1177] If a taxpayer has engaged in a listed transaction and has failed to include on any return or statement for any taxable year any information required under section 6011 to be included with such return or statement, the statute of limitations with respect to such transaction will not expire before the date which is one year after the earlier of: (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in section 6111) satisfies the list maintenance requirements (as defined in section 6112) with respect to a request by the Secretary.[1178] In the case of a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.[1179] The statute of limitations also may be extended by taxpayer consent.[1180]

Description of Proposal

The proposal creates an additional exception to the general three-year statute of limitations for assessment of Federal tax liability resulting from adjustments to State or local tax liability. The statute of limitations is extended to the greater of: (1) one year from the date the taxpayer first files an amended tax return with the IRS reflecting adjustments to the State or local tax return; or (2) two years from the date the IRS first receives information from the State or local revenue agency under an information sharing agreement in place between the IRS and a State or local revenue agency. The statute of limitations is extended only with respect to the increase in Federal tax attributable to the State or local tax adjustment. The statute of limitations is not further extended if the taxpayer files additional amended returns for the same tax periods as the initial amended return or if the IRS receives additional information from the State or local revenue agency under an information sharing agreement.

The statute of limitations on claims for refund is extended correspondingly so that any overall increase in tax assessed by the IRS as a result of the State or local examination report

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[1175] For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[1176] Sec. 6511.

[1177] Sec. 6501(e).

[1178] Sec. 6501(c)(10).

[1179] Sec. 6501(c).

[1180] Sec. 6501(c)(4).

would take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

Effective date.–The proposal is effective for returns required to be filed after December 31, 2010.

Analysis

Congress has regarded it as "ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values, and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensible element of fairness as well as of practical administration of an income tax policy."[1181]

There are a number of exceptions to the general three-year statute of limitations, many of which are premised on the theory that the statute of limitations should not run when the taxpayer has not disclosed facts that allow the IRS to make an accurate assessment. For example, there is no statute of limitations in the case of a false or fraudulent return. In that case, the taxpayer who has filed a fraudulent return with intent to evade tax hardly is in a position to complain of the fairness of a rule that facilitates the IRS's collection of the tax due. Similarly, where a taxpayer has omitted substantial items of income, the IRS is provided with an additional three years to make an assessment.[1182]

The statute of limitations is also extended beyond the general three years in the case of foreign tax credits. The IRS may assess a deficiency attributable to the reduction of excess foreign tax credits or disallowed foreign oil and gas taxes for a period of up to one year after the statute of limitations would generally expire for the taxable year of the excess or disallowed credits resulting in the carryback.[1183] To the extent that the proposal permits both the taxpayer and the IRS to adjust the Federal return to reflect the corrected State or local tax, it would be somewhat analogous to the treatment of foreign tax credits.

The proposal extends the statute of limitations in cases where adjustments to State or local taxes create an additional Federal tax liability. Proponents argue that an extension is appropriate because the IRS is often unaware of a State or local adjustment affecting Federal tax liability until the general three-year statute of limitations has expired, while the taxpayer is aware of such adjustment. The limited resources available for examinations of returns necessarily results in relatively few audits; this proposal permits the IRS to leverage the information received from a State or local agency to determine whether to select the return for examination.

[1181] *Rothensies v. Electric Storage Battery Co.,* 329 U.S. 296, 300 (1946).

[1182] Sec. 6501(e).

[1183] Sec. 6501(i).

The factual basis of that argument assumes that the taxpayer understands the relationship between State and Federal income tax liabilities, and is simply concealing the State or local proceeding and determination from the IRS. Opponents of the proposal may argue that such an assumption is not warranted. The mere fact of a State or local revenue agency determination is distinguishable from other situations in which the statute of limitations is extended, such as those in which a taxpayer fails to disclose information on a tax return. A State or local tax adjustment may or may not be based on information that is available from the face of the filed tax return. If the information necessary to make an adjustment is available from the face of the return (i.e., the taxpayer did not fail to disclose information), one may argue that the burden should be on the taxing agencies to share information in a manner that would allow assessments to be made in a timely manner, rather than placing the burden on the taxpayer to notify the IRS of a State or local determination. Rather than providing a general exception to the statute of limitations in the case of any State or local determination affecting Federal tax liability, the proposed extension of the limitations period could be limited in some manner. For example, the statute could provide the exception does not apply if a taxpayer can demonstrate that information adequate to identify the issue raised by the State or local authorities was disclosed on the Federal return. Alternatively, the statute could provide that the exception only applies if, in addition to the existence of a State tax adjustment, the resulting Federal adjustment would support assertion of an accuracy penalty under section 6662.

The proposal permits an extension of the statute based on notice from the State or local agency to the IRS under an information sharing agreement. Accordingly, the date on which such notice is first provided to the IRS may determine the extent to which the limitations period is extended, but is not within the taxpayer's control or knowledge. In contrast, most of the exceptions to the three-year limitations period are based on information that is clearly available to the taxpayer. If this proposal is adopted, a mechanism to provide the taxpayer with contemporaneous notice that the State has notified the IRS should be considered.

Prior Action

A similar proposal was included in the President's budget for fiscal years 2009 and 2010.

17. Improve investigative disclosure statute

Present Law

The Code defines return information very broadly, including a taxpayer's identity and "whether the taxpayer's return was, is being, or will be examined or subject to other investigation." In general, returns and return information are confidential and cannot be disclosed unless an exception to this general rule applies. One exception permits Treasury and IRS personnel to disclose return information to the extent necessary to obtain information not otherwise reasonably available in the course of an audit or investigation as prescribed by regulation.[1184] A "disclosure of return information to the extent necessary" is a facts-and-circumstances test in which the Treasury or IRS employee reasonably believes a disclosure of

[1184] Sec. 6103(k)(6).

return information is necessary to obtain information to perform properly his or her official duties, or to accomplish properly the activities connected with carrying out those official duties. In this context, the term "necessary" does not mean essential or indispensible, but rather "appropriate and helpful in obtaining the information sought."[1185]

The Treasury regulations already permit Treasury and IRS personnel to identify themselves, their organizational affiliation, and the nature of an investigation when contacting third parties in connection with a civil or criminal tax investigation:

> Internal Revenue and TIGTA employees may identify themselves, their organizational affiliation (e.g., Internal Revenue Service (IRS), Criminal Investigation (CI) or TIGTA, Office of Investigations (OI)), and the nature of their investigation, when making an oral, written or electronic contact with a third party witness. Permitted disclosures include, but are not limited to, the use and presentation of any identification media (such as a Federal agency badge, credential, or business card) or the use of an information document request, summons, or correspondence on Federal agency letterhead or which bears a return address or signature block that reveals affiliation with the Federal agency.[1186]

The Treasury regulations do not specifically provide that the identity of the taxpayer under investigation may be disclosed routinely as part of the IRS employee's identification of the nature of the investigation. The IRS has been the subject of lawsuits over the disclosure of the fact that a taxpayer is under criminal investigation.[1187]

Description of Proposal

Section 6103 is amended to provide that Treasury and IRS officers and employees are not prohibited from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

Effective date.−The proposal is effective for disclosures made after the date of enactment.

Analysis

The proposal would make it unnecessary for a revenue agent to determine whether it is necessary to disclose the nature and subject of an investigation (including the identity of the person being investigated) when contacting third parties in connection with a civil or criminal tax investigation. Some argue that identifying the taxpayer and the nature of the investigation (civil or criminal) are items of tax information that every witness will want to know. On the other hand, some may argue that there is a particular sensitivity to associating a taxpayer with a

[1185] I.R.M. 11.3.21.2 (03-28-2008).

[1186] Treas. Reg. sec. 301.6103(k)(6)-1(a)(3).

[1187] For example, see *Snider v. United States*, 468 F.3d 500 (8th Cir. 2006); *Gandy v. United States*, 234 F.3d 281 (5th Cir. 2000).

criminal investigation and that such disclosures should only be made if the witness is not willing to provide the information sought without such a disclosure.

Proponents of the proposal argue that eliminating the facts-and-circumstances test with respect to the disclosure of taxpayer identity would bring some certainty as to what is a permissible disclosure. However, some may argue that the balance between a taxpayer's reasonable expectation of privacy and effective tax administration is upset if the IRS is given blanket authority to disclose the nature and target of an investigation in all circumstances. Proponents of the proposal note, however, that the disclosure is permissive rather than mandatory and that agents may still use their discretion as to whether a disclosure is necessary.

Prior Action

The same proposal was included in the President's fiscal year 2009 and 2010 budget proposals.

18. Clarify that the bad check penalty applies to electronic checks and other payment forms

A substantially similar proposal to the President's fiscal year 2011 budget proposal was enacted as part of section 3 of the "Homebuyer Assistance and Improvement Act of 2010."[1188]

19. Impose a penalty on failure to comply with electronic filing of returns

Present Law

The Code authorizes the IRS to issue regulations specifying which returns must be filed electronically.[1189] There are several limitations on this authority. First, it can only apply to persons required to file at least 250 returns during the year.[1190] Second, the IRS is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper.

If a corporation fails to file electronically a corporate income tax return when required, the corporation is deemed to have failed to file a return.[1191] The addition to tax for failure to file

[1188] Pub. L. No. 111-198 (2010). The effective date of this new law is for instruments tendered after July 2, 2010 (enactment date) while the President's Budget Proposal is effective for returns required to be filed after December 31, 2010. The President's Fiscal Year 2010 Budget Proposal also contained this provision effective for returns required to be filed after December 31, 2009.

[1189] Sec. 6011(e). For returns filed after December 31, 2010, individual income tax returns are required to be filed electronically if the return is filed by a tax return preparer that files more than ten individual tax returns during the year. Sec. 6011(e)(3).

[1190] Partnerships with more than 100 partners are required to file electronically. Sec. 6011(e)(2).

[1191] Treas. Reg. Sec. 301.6011-5(c).

a return is five percent of the amount of tax required to be shown on the return for the first month and an additional five percent for each additional month (or fraction thereof) up to 25 percent.

For failure to file a tax-exempt organization return, the addition to tax is $20 a day for each day the failure continues. The maximum amount per return is the lesser of $10,000 or 5 percent of the organization's gross receipts for the year. Organizations with annual gross receipts exceeding $1 million, however, are subject to an addition to tax of $100 per day, with a maximum amount of $50,000.

The Code specifically authorizes the Secretary to offer incentives to encourage electronic filing.

Description of Proposal

The proposal would establish an assessable penalty in the amount of $25,000 for a corporation or $5,000 for a tax-exempt organization for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. For failure to file in any format, the existing penalty would remain, and the proposed penalty would not apply.

Effective date.–The proposal is effective for returns required to be electronically filed after December 31, 2011.

Analysis

Proponents of the penalty may argue that a penalty is justified because electronic filing promotes efficiency and provides cost savings for the IRS. Electronic filing increases efficiency because the IRS is better able to make use of its computer infrastructure to target returns with audit potential. This focus, in turn, allows the IRS to utilize its resources in areas in which such efforts would be most fruitful.

In support, proponents may point to the GAO study which reported that electronic filing has enabled the IRS to close two paper processing centers and save 1,600 staff years.[1192] Along similar lines, the Treasury Inspector General also has noted significant cost saving, reporting that a paper return is over nine times more costly to process than a return submitted electronically and has a far greater error rate.[1193]

Others may argue that, despite the foregoing facts about increased efficiencies, a $25,000 penalty is disproportionate to any costs or efficiency loss incurred by the IRS. Opponents note

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[1192] Government Accountability Office, Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings, GAO-07-27, November 2006, p.3.

[1193] It costs the IRS only $0.35 to process an e-filed return, versus $2.87 for a paper filed return, according to a study. Higher rates of errors on paper returns are attributed to the need to input information into IRS computers. Treasury Inspector General for Tax Administration, *Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs,* TIGTA 2009-40-130, September 10, 2009.

that the IRS already has the ability to penalize noncompliance with mandatory e-filing regulations. Under the Treasury regulations, failure to file electronically when required to do so can be treated as a failure to file a return, thus triggering the existing penalty for failing to file. As a result, a new monetary penalty is unnecessary. In addition, the treating of a paper return as not having been filed has harsh results in circumstances in which elections are made on such returns, and operates as a disincentive to ignore the e-file mandate.

However, advocates for a penalty specific to e-filing failures argue that the existing penalty is inadequate to promote e-filing because it is linked to the existence of an underpayment of tax. Thus, a corporation entitled to a refund or credit may not incur a penalty.

Some may argue that the IRS should use incentives, as authorized by the Code, rather than penalties to encourage electronic filing. Proponents of the proposal counter that it is not necessary for the IRS to offer incentives for what taxpayers are obligated to do and that in the absence of hardship, the burden on a taxpayer to file electronically is minimal and yields significant tax administration benefits for the IRS.

Prior Action

A similar proposal was included in the President's fiscal year 2008, 2009 and 2010 budget proposals.

20. Require consistency in value for transfer and income tax purposes

Present Law

The value of an asset for purposes of the estate tax is the fair market value at the time of death or at the alternate valuation date. The basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death or as of an alternate valuation date, if elected by the executor. Under regulations, the fair market value of the property at the date of the decedent's death (or alternate valuation date) is deemed to be its value as appraised for estate tax purposes.[1194] However, the value of property as reported on the decedent's estate tax return provides only a rebuttable presumption of the property's basis in the hands of the heir.[1195] Unless the heir is estopped by his or her previous actions or statements with regard to the estate tax valuation, the heir may rebut the use of the estate's valuation as his or her basis by clear and convincing evidence. The heir is free to rebut the presumption in two situations: (1) the heir has not used the estate tax value for tax purposes, the IRS has not relied on the heir's representations, and the statute of limitations on assessments has not barred adjustments; and (2) the heir does not have a special relationship to the estate which imposes a duty of consistency.[1196]

[1194] Treas. Reg. sec. 1.1014-3(a).

[1195] See Rev. Rul. 54-97, 1954-1 C.B. 113.

[1196] See TAM 199933001 (January 7, 1999).

For property acquired by gift, the basis of the property in the hands of the donee generally is the same as it was in the hands of the donor. However, for the purpose of determining loss on subsequent sale, the basis of property in the hands of the donee is the lesser of the donor's basis or the fair market value of the property at the time of the gift.[1197]

Description of Proposal

The proposal requires that the basis of property received by reason of death under section 1014 generally must equal the value of that property claimed by the decedent's estate for estate tax purposes. The basis of property received by lifetime gift generally must equal the donor's basis determined under section 1015. Under the proposal, the basis in the hands of the recipient can be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments).

In addition to requiring consistency in values for transfer and income tax purposes, the proposal imposes a reporting requirement. The executor of a decedent's estate and the donor of a lifetime gift are required to report to both the recipient and the IRS the information necessary to determine the recipient's basis under the proposal.

The proposal provides for regulatory authority necessary to implement and administer the requirements of the proposal, including establishing rules for: (1) situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503 (e.g., pursuant to the gift tax annual exclusion); (2) situations in which the surviving joint tenant or other recipient may have better information than the executor; and (3) the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

Effective date.−The proposal is effective on the date of enactment.

Analysis

Providing an heir with fair market value information gives the heir records to improve reporting of income upon future realization of gain. Providing the IRS with the same information would better enable the IRS to challenge attempts to underreport gain upon a subsequent realization of that gain.

Under present law, generally the incentive exists for an executor of an estate or a donor of a lifetime gift to offer low estimates of the value of assets for estate or gift tax purposes in order to minimize the amount of transfer tax. For the purpose of determining gain or loss on an inherited asset or on an asset received by gift, however, generally the recipient would prefer a higher basis.[1198] The government is potentially whipsawed by inconsistent valuations. For

[1197] Sec. 1015(a).

[1198] This preference is especially clear in the case of a spouse of the decedent. That spouse will not, for example, bear the burden of an estate tax on his or her bequest. Other beneficiaries generally will bear the burden of the estate tax and therefore may have competing preferences.

example, the IRS has ruled that while value as appraised for estate tax purposes provides a presumptive value for the basis of inherited property in the hands of a beneficiary, such estate tax valuation generally is not conclusive.[1199] In a case discussed in a technical advice memorandum,[1200] at the time of the decedent's death the taxpayer owned stock in two closely held corporations. On audit, the IRS proposed a higher value for the stock than the value the executor provided on the estate tax return. The estate subsequently argued for a lower valuation and the IRS agreed to an amount in between the two parties' initial valuations. Following a redemption of the inherited stock from the beneficiary, the beneficiary (in an amended return for the taxable year of redemption) claimed a basis in the stock that was higher than both the original estate tax return value and the agreed upon value.

Underlying the rebuttable presumption rule set forth in the technical advice memorandum is the theory that a taxpayer should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination or benefit from it. This theory represents an application of an estoppel principle that is used outside the context of the estate tax. Where, however, a taxpayer succeeds in presenting clear and convincing evidence of a higher basis than the value used for estate tax purposes, this principle conflicts with one rationale for the section 1014 basis step-up rule, which applies for purposes of determining the basis in assets acquired from a decedent who died before 2010 or who dies after 2010.[1201] Some analysts argue that the step-up of an asset's basis at death is an appropriate adjustment to prevent property transferred at death from being subject to both Federal income tax and estate tax. If the basis in the hands of the heir exceeds the value used for estate tax purposes, an exemption from income tax in excess of the appreciation in decedent's hands has been created. By helping to ensure consistency in value for estate and income tax purposes, the proposal at least mitigates the whipsawing of the government that may occur under present law.

In general, in the computation of capital gain or loss, establishing basis in property is a problem for taxpayers and the IRS, because the basis in the property becomes important for determining tax liability only when the asset is sold, often many years after the asset is acquired. Taxpayers may lose records in the interim. The difficulty would be particularly acute where the taxpayer did not purchase the asset in question and consequently would have no records (e.g., receipts or other purchase documentation) to begin with. Thus, another rationale for the basis step-up rule of present law section 1014 is to provide administrative simplicity for the heir and the IRS because the heir's fair market value basis will potentially already have been determined for estate tax purposes. The proposal achieves this administrative goal by having basis reported

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[1199] In Rev. Rul. 54-97, 1954-1 C.B. 113, the IRS concluded, "Except where the taxpayer is estopped by his previous actions or statements, such value [the value of the property as determined for estate tax purposes] is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence."

[1200] TAM 199933001 (January 7, 1999).

[1201] For assets acquired from a decedent who dies during 2010, the basis step-up rules of section 1014 are repealed and replaced with the modified carryover basis rules of section 1022. However, a separate budget proposal would make permanent the estate and gift tax laws that were in effect in 2009, including the section 1014 step-up in basis rules.

at the time an asset is bequeathed, thereby establishing a record comparable to purchase documentation. Present law arguably fails to achieve this objective, both because the executor is not required to report the estate tax value to the heir, and because the heir is not required in all cases to use such value in determining basis.

Under the proposal there would be instances in which the value of an asset reported by an executor to an heir differs from the ultimate value of the asset used for estate tax purposes. For example, if the IRS challenges an estate valuation and prevails, the executor will have reported to the heir a valuation that is artificially low, and the heir may arguably be overtaxed on a subsequent sale of the asset. This same problem exists under present law to the extent the initially reported estate tax value is presumptively the heir's basis. To provide complete consistency between estate tax valuation and basis in the hands of an heir may be impractical as ultimate determination of value for estate tax purposes may depend upon litigation, and an heir may sell an asset before the determination of value for estate tax purposes. Nevertheless, supplemental reporting requirements would be imposed for post-filing adjustment of the fair market value as determined for Federal estate or gift tax purpose.

Under the proposal, the basis in the hands of the recipient can be no *greater than* the value of that property as determined for estate or gift tax purposes. Where a recipient of a gift or bequest believes the transferor overstated the value of transferred property for transfer tax purposes, it is the understanding of the Joint Committee staff that the proposal would permit the recipient to claim a basis *lower than* the value claimed for transfer tax purposes. This rule likely is designed to protect recipients of gifts and bequests from accuracy-related penalties under section 6662 on a subsequent disposition of property in situations in which the transferor overstated the value of such property for transfer tax purposes.

Prior Action

Similar proposals were included in the President's fiscal year 2000, 2001, and 2010 budget proposals.

21. Modify rules on transfer tax valuation discounts

Present Law

In general

The value of property subject to transfer taxes is the fair market value of the property being transferred on the date of transfer.[1202] The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[1203]

[1202] Secs. 2031 (estate tax), 2512 (gift tax), and 2624 (generation-skipping transfer tax). Fair market value is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternate valuation date if the executor so elects) in the case of the estate tax.

[1203] Treas. Reg. secs. 20.2031-1(b) and 25.2512-1.

If actual sales prices and bona fide bid and ask prices are lacking, the fair market value of stock in a closely held business is determined by looking to various factors including: the company's net worth; its prospective earning power and dividend-paying capacity; the goodwill of the business; the economic outlook in the nation and in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of businesses.[1204]

Discounts

In general

Courts and the IRS have recognized that for various reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. For example, the value of stock held by a 50-percent shareholder might differ from the value of 50 percent of the assets owned by the corporation in which the stock is held. Some (but not all) of the valuation discounts used under present law are discussed below.[1205] In many cases courts apply more than one discount. The theories of some discounts overlap, and court decisions sometimes blur the distinctions between those discounts.

Minority (or lack of control) discount

Numerous courts and the IRS have recognized that shares of stock or other ownership interests in a closely-held business entity that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the entity.[1206] Minority discounts arise

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[1204] Treas. Reg. secs. 20.2031-2(f)(2) and 25.2512-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237.

[1205] Other valuation discounts that courts have recognized include a blockage discount (if the sale of a block of assets, such as 80 percent of the stock of a public company, would depress the market for that asset); a key man (thin management) discount (if the value of a business declines due to the loss of a key manager); and a capital gain (or *General Utilities)* discount (to reflect the tax on gain from the eventual sale of assets acquired by gift or held by a corporation).

[1206] See Rev. Rul. 93-12, 1993-2 C.B. 202; *Propstra v. United States,* 680 F.2d 1248 (9th Cir. 1982); *Ward v. Commissioner,* 87 T.C. 78 (1986); *Estate of Leyman v. Commissioner,* 40 T.C. 100 (1963). More recently, a minority discount was allowed even where the total shares owned by related persons constituted a majority interest. For example, in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court upheld a minority discount on stock transferred to a trust even though the other principal shareholder of the corporation was trustee of the trust and father of its beneficiary.

In *Pierre v. Commissioner*, 133 T.C. 2 (2009), the Tax Court allowed minority and marketability discounts in valuing transfers of interests in a single member LLC to trusts established for the transferor's children. The taxpayer had funded the LLC with cash and marketable securities 12 days before she transferred the LLC interests to the trusts. Although the LLC was treated as a disregarded entity for Federal tax purposes under the "check-the-box" regulations, the court rejected the Service's argument that the taxpayer should be treated as having transferred for Federal gift tax purposes a proportionate share of the underlying assets of the LLC and thus should not be entitled to claim valuation discounts. The court reasoned that State law controlled the determination of what property interests were transferred for Federal transfer tax purposes; under State law, the LLC was a separate legal entity, and the from a division of control because the holder of a minority interest cannot control the ongoing direction of the business entity, the timing and amount of income distributed by the entity to its owners, or the liquidation of its assets. Minority discounts often result in reductions in the value of transferred property from 15 percent to 40 percent.[1207]

Marketability (or illiquidity) discount

Recognizing that closely held stock and partnership interests often are less attractive to investors and have fewer potential purchasers than publicly traded stock, courts and the IRS grant discounts to reflect the illiquidity of such interests. Courts sometimes combine marketability and minority discounts into a single discount,[1208] but the discounts reflect different concerns. Whereas the minority discount compensates for lack of control over an interest, the marketability discount compensates for the limitations upon free exit inherent in interests for which no public market exists. The marketability discount may be appropriate whether valuing a controlling or a minority ownership interest.[1209] Generally, the size of the marketability discount is reduced as the donor's or decedent's control of the corporation or partnership increases. However, the discount has been applied to a 100-percent ownership interest in a closely-held corporation.[1210] Marketability discounts often result in reductions in the value of transferred property of 20 to 30 percent[1211] in addition to any applicable minority discount.[1212]

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taxpayer did not have a property interest in the underlying assets of the LLC. In its opinion, the court noted that "Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically."

[1207] See David T. Lewis and Andrea Chomakos, The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities (ABA Publishing 2004) at 11.

[1208] E.g., *Central Trust Co. v. United States*, 305 F.2d 393 (Ct. Cl. 1962); *Estate of Titus v. Commissioner*, T.C. Memo 1989-466.

[1209] Controlling shares in a nonpublic corporation, which do not qualify for a minority discount, may nonetheless receive a marketability discount because there is no ready private placement market and because transaction costs would be incurred if the corporation were to publicly offer its stock.

[1210] See, e.g., *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34, in which the Tax Court concluded that in determining the discount, the corporate form could not be ignored. ("Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties.").

[1211] There is no established formula to compute the size of a discount. One measure of the size of a discount, applicable when valuing a controlling interest, is the total cost of registering securities with the Securities and Exchange Commission, i.e., converting nonliquid securities into liquid ones. Other factors considered are the size of any costs and the amounts realizable on a private placement or secondary offering, the opportunity cost of losing access to the invested funds, and the discounts applied in comparable transactions involving sales of comparable closely held businesses.

[1212] The Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-

Marketability discounts often are created by placing assets in a limited partnership. Marketability discounts created through the use of a limited partnership permit the donee or legatee to recreate value by liquidating the partnership or having a partner's interest redeemed by the partnership.

Fragmentation (or fractional interest) discount

Fragmentation discounts are similar to minority discounts. This discount arises from the lack of control inherent in joint ownership of an asset (e.g., a gift of an undivided fractional interest in real estate).[1213] Fragmentation discounts often result in reductions in the value of transferred property of 15 to 60 percent.[1214]

Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and companies. These discounts can be as high as 50 percent and may overlap with the marketability discount.[1215]

Special rules regarding restrictions on liquidation (section 2704(b))

Restrictions on the liquidation of an entity (or of an interest in an entity) sometimes serve as the basis for a marketability discount. Where the entity is family-controlled, however, some believe that such restrictions are included in governing documents principally to achieve a reduction in value for transfer tax purposes, but that the claimed reduction in value does not reflect the true economic value of a transferred interest in the hands of the transferee.[1216]

To address this concern, section 2704(b) provides that certain "applicable restrictions" are disregarded in determining the value of a transferred interest if the transfer is of an interest in

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percent marketability discount should result in a 52-percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. See *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

[1213] Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount should reflect the cost of partition and the value of the interest secured thereby. See Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Estates, Gifts, and Trusts*, para. 135.3.4 (2d ed. 1993). Courts, however, often apply a minority discount instead. See, e.g., *LeFrak v. Commissioner*, T.C. Memo 1993-526.

[1214] See, e.g., *Estate of Van Loben Sels v. Commissioner*, T.C. Memo 1986-501.

[1215] For example, the Tax Court in *Estate of Folks v. Commissioner*, T.C. Memo 1982-43, granted the taxpayer a 50-percent investment company discount and then applied to the resulting value a 50-percent marketability discount, resulting in a total discount of 75 percent.

[1216] See H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1028, 1137-1138 (1990).

a corporation or partnership to or for the benefit of a member of the transferor's family,[1217] and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity.[1218] An applicable restriction is a restriction that effectively limits the ability of the entity to liquidate, where (1) the restriction lapses, in whole or in part, after the transfer, or (2) the transferor or any member of the transferor's family, either alone or together, has the right after the transfer to remove, in whole or in part, the restriction.[1219] An applicable restriction does not include commercially reasonable restrictions that arise as part of certain third-party financing arrangements, or any restriction imposed, or required to be imposed, by any Federal or State law.[1220] Section 2704(b) grants the Secretary broad regulatory authority to disregard any other restriction that reduces the transfer tax value of an interest but does not reduce the value of such interest to the transferee.[1221]

Since the enactment of section 2704(b), new State statutes providing for more restrictive liquidation rights, as well as regulatory and judicial interpretations of section 2704(b), arguably have limited the provision's effectiveness in curbing inappropriate marketability discounts. In its opinion in *Kerr v. Commissioner*,[1222] for example, the Tax Court asserted that current Treasury regulations expand the Code-based exception that excludes from the definition of "applicable restriction" certain State or Federal law liquidation restrictions. Indeed, instead of limiting the exception to restrictions *imposed or required to be imposed* by law (as under the language of section 2704(b)(3)(B)), the regulations provide that "[a]n applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) *that is more restrictive than* the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."[1223] The IRS generally has been unsuccessful in arguing for a more limited interpretation of this exception in court cases in which the breadth of the exception is at issue.[1224]

Description of Proposal

The proposal modifies section 2704(b) to create a category of "disregarded restrictions" that would be ignored when valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the

[1217] For purposes of section 2704, a family member includes, with respect to an individual: (1) a spouse; (2) ancestors and lineal descendants; (3) brothers and sisters; and (4) spouses of an individual described in (2) or (3). Sec. 2704(c)(2).

[1218] Sec. 2704(b)(1).

[1219] Sec. 2704(b)(2).

[1220] Sec. 2704(b)(3).

[1221] Sec. 2704(b)(4).

[1222] 113 T.C. 449, 472 (1999), *aff'd*. 202 F.3d 490 (5th Cir. 2002).

[1223] Treas. Reg. sec. 25.2704-2(b) (emphasis added).

[1224] See, e.g., *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*. 202 F.3d 490 (5th Cir. 2002); *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001).

transferor and/or the transferor's family. The proposal provides that the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations.

The proposal provides that disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest in the family-controlled entity that are more restrictive than a standard to be specified in regulations. A disregarded restriction also would include a limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. In determining whether a restriction may be removed by one or more members of the family after a transfer, certain interests held by charities or others who are not family members would be deemed to be held by the family. Such interests are to be identified in regulations.

Under the proposal, regulatory authority is granted, including the ability to create safe harbors under which the governing documents of a family-controlled entity could be drafted so as to avoid the application of section 2704 if certain standards are met. The proposal includes conforming changes relating to the interaction of the proposal with the transfer tax marital and charitable deductions.

<u>Effective date</u>.−The proposal is effective for transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

Analysis

Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. In some cases these reductions in value for estate and gift tax purposes do not accurately reflect economic value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer's child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.[1225]

[1225] Commentators have referred to this discounting as the "disappearing wealth" phenomenon: Wealth disappears from the transfer tax base even though no (or little) actual economic value is lost. See Mary Louise Fellows and William H. Painter, "Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome," 30 *Stanford Law Review* 895 (1978); James Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation," 50 *Tax Law Review* (1995); Laura E. Cunningham, "Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP," 86 *Tax Notes* 1461 (2000).

Church v. United States, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001), provides a simple example of the creation of discounts shortly before death. Mrs. Church, who was the mother of the plaintiff and was suffering from a terminal illness, and her two children together formed a limited partnership. In exchange for limited partnership interests, Mrs. Church contributed to the partnership her

The proposal seeks to curb the use of family limited partnerships ("FLPs") and LLCs to create valuation discounts, specifically marketability (i.e., liquidity) discounts. The proposal would achieve this goal through a more robust version of section 2704(b), under which taxpayers would be subject to greater limits on marketability discounts arising from liquidation restrictions when transferring interests in family-controlled entities. Specifically, the proposal would create a new class of "disregarded restrictions" that are ignored when valuing such an interest. Disregarded restrictions would include certain liquidation restrictions, as well as a limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. The proposal thus seeks to limit the use of a strategy frequently employed to manufacture discounts that do not reflect the economics of the transfers during life and after death, namely, the inclusion in governing documents of purported restrictions that do not reflect economic reality. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation.

Some may argue that the proposal does not specify or adequately describe the liquidation restrictions that will be disregarded in valuing a transfer of a family-controlled entity or other key aspects of the proposal; therefore, it is difficult to assess whether the proposal would be effective. As described above, the proposal establishes new "disregarded restrictions" that would be ignored in valuing an interest in a family-controlled entity. The Treasury Department provides that "the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations."[1226] The proposal, however, does not describe the assumptions that would be specified in regulations. Without such information, it is difficult to determine how the proposal is intended to operate. In addition, the Treasury Department provides that "[d]isregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations."[1227] One could speculate that this regulatory standard is intended in part to address interpretive concerns that have arisen regarding the present-law exception for restrictions that are imposed or required to be imposed under State or Federal law. The proposal, however, does not provide information from which one could determine what such a regulatory standard might include or whether such a standard might also be intended to address other concerns.[1228]

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interest in a Texas ranch (valued at $380,038) together with $1,087,710 in publicly traded securities, while her two children contributed their undivided interests in the ranch. A corporation owned equally by the two children was the general partner of the partnership. Two days after the formation of the partnership, Mrs. Church died. The District Court found that the date-of-death value of Mrs. Church's limited partnership interest was $617,591, despite the fact that Mrs. Church transferred assets to the partnership worth $1,467,748 just two days earlier. The court upheld a 58-percent discount based upon the noncontrolling and illiquid nature of Mrs. Church's limited partnership interest.

[1226] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (Feb. 2010), p. 124.

[1227] *Ibid*.

[1228] The Treasury Department also provides that, in determining whether a restriction may be removed by a family member following a transfer, certain interests held by charities or others who are not family members would be deemed to be held by the family; these interests are not described in the proposal, but would be "identified in regulations." Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (Feb. 2010), p. 124.

Some also may argue that, even in the absence of the proposal, the Secretary has broad authority under section 2704(b)(4) to issue new regulations establishing restrictions that must be disregarded in valuing transfers of an interest in a family-controlled entity; the proposal, under which many important details are left to regulations, arguably adds little to this present-law authority. The Tax Court in *Kerr v. Commissioner* stated that it was "mindful that the Secretary has been vested with broad regulatory authority under section 2704(b)(4)," but concluded that the current Treasury regulations did not support the IRS's position in the case.[1229] This statement by the *Kerr* court suggests that the court believed that the Secretary already has the authority to issue new, more restrictive regulations under section 2704(b). Furthermore, the IRS and Treasury business plan for 2008-2009 described a plan to issue guidance under section 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership. The Treasury Department's explicit plan to issue new guidance under section 2704(b) arguably raises questions about whether a legislative modification of this section is premature or even necessary.

Because the proposal targets only marketability discounts arising from liquidation restrictions, some may argue that a broader approach would be preferable. If, for example, an entity whose interests are nonmarketable holds marketable assets, a marketability discount for an interest in the entity results in the undervaluing of the interest if the owner has a controlling interest in the entity and can easily access the marketable assets. Some other proposals have sought to curb this practice by imposing "look through" rules under which a marketability discount generally is denied to the extent an entity holds marketable assets.[1230] These proposals would apply even in the absence of liquidation restrictions. If the Administration's fiscal year 2011 budget proposal were enacted, taxpayers might seek to take advantage of marketability discounts through structures that did not depend on liquidation restrictions.

Furthermore, because the proposal targets only marketability discounts, it would not directly address minority discounts that do not accurately reflect the economics of a transfer. Some other proposals have sought to address certain excessive minority discounts more directly through aggregation of certain interests when determining whether a transferred interest in an entity should be valued as a minority interest. In 2005, the staff of the Joint Committee on Taxation published a proposal that includes such aggregation rules. Under the basic aggregation rule of the staff proposal, the value for transfer tax purposes of an asset transferred by a donor or decedent generally is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferor immediately before the transfer.[1231] Under a separate aggregation rule

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[1229] 113 T.C. 449, 474 (1999).

[1230] See, e.g., Staff of the Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 27, 2005), pp. 396-404; Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (February 1999) at 167; Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* (February 2000) at 184-85; H.R. 436, *Certain Estate Tax Relief Act of 2009* (111th Cong., 1st Sess.).

[1231] The basic aggregation rule is similar to a proposal made by the Treasury Department in 1984 as part of a broad report on tax reform. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth, vol. 2, General Explanation of the Treasury Department Proposals* (November 1984) at 386-88. The 1984 proposal, however, based the value of transferred property on the transferor's highest level of ownership after taking included in the proposal, if a donor or decedent did not own a controlling interest in an asset immediately before a transfer, but in the hands of the donee or heir, the transferred asset is part of a controlling interest, the transfer tax value of the transferred interest is a pro-rata share of the fair market value of the entire interest in the asset owned by the donee or heir after taking into account the gift or bequest.

Some other proposals have addressed minority discounts through rules that attribute ownership among family members. For example, one recently introduced bill, the Certain Estate Tax Relief Act of 2009, would deny a minority discount in connection with the transfer of an interest where the transferee and members of the transferee's family together have control of the entity.[1232] For purposes of the bill, a member of the family is defined broadly to include, among others, the transferee's ancestors, spouse, lineal descendants, siblings, and spouses of lineal descendants. Although the Administration's budget proposal considers family relationships in determining whether a restriction on liquidation could be removed for purposes of section 2704(b), it does not include a family attribution rule that addresses the inappropriate use of minority discounts where family members control an entity. Some may argue, however, that such a family attribution rule would be inappropriate, because it is not correct to assume that individuals always will cooperate with one another merely because they are related.

Prior Action

The proposal was contained in the President's fiscal year 2010 budget proposal. Different proposals to reform transfer tax valuation discounts were included in the President's Fiscal Years 2000 and 2001 budget proposals.

22. 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).[1233] 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.[1234] 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.

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into account prior gifts. This tracing of ownership backward through all gifts made by a transferor during his or her lifetime arguably would create administrative difficulties.

[1232] H.R. 436, *Certain Estate Tax Relief Act of 2009* (111th Cong., 1st Sess.).

[1233] See sec. 2702.

[1234] See secs. 671-679.

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.[1235] In general, the value of any retained interest that is not a "qualified interest" is treated as zero.[1236] 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.[1237] 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.[1238]

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).[1239]

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.[1240] 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

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[1235] Sec. 2702(a)(1).

[1236] Sec. 2702(a)(2)(A).

[1237] 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).

[1238] Sec. 2702(a)(2)(B); sec. 7520.

[1239] Sec. 2702(b).

[1240] See secs. 671-679.

of the trust attributable to the portion of the trust deemed owned by the grantor for income tax purposes.[1241]

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.[1242] A grantor may, for example, be treated as the owner of a trust for income tax purposes where the grantor has: (1) a reversionary interest in the corpus or income of the trust;[1243] (2) the power to control beneficial enjoyment of the corpus or income of the trust;[1244] (3) certain administrative powers;[1245] (4) the power to revoke all or part of the trust;[1246] or (5) the power to distribute income to or for the benefit of the grantor.[1247]

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 under 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.[1248] The trustee must be required to invade the principal of the trust in the event the income is insufficient to pay the qualified annuity.

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

[1241] See sec. 671.

[1242] See secs. 673-677.

[1243] Sec. 673.

[1244] Sec. 674.

[1245] Sec. 675.

[1246] Sec. 676.

[1247] Sec. 677.

[1248] Treas. Reg. sec. 25.2702-3(b).

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 satisfy the annuity amount will be included in the grantor's gross estate for estate tax purposes.[1249] Such inclusion generally results in the loss of the transfer tax benefit of using a GRAT.

To the extent a GRAT is structured as a grantor trust, the grantor is treated as owner of the trust and must include in determining his or her taxable income and credits those items of income, deductions, and credits of the portion of the trust deemed owned by the grantor.

Description of Proposal

The proposal requires that a GRAT have a minimum term of 10 years. The proposal also requires that the remainder interest of a GRAT have a value greater than zero and prohibits any decrease in the annuity during the GRAT term.

Effective date.−The proposal is effective for trusts created after the date of enactment.

Analysis

The valuation rates and tables prescribed by section 7520 often produce relative values of annuity and remainder interests in a GRAT that are not consistent with actual returns on trust assets. As a result, under present law, taxpayers often use GRATs to make gifts of property with little or no transfer tax consequences, so long as the investment return on assets in the trust is greater than the rate of return assumed under section 7520 for purposes of valuing the lead and remainder interests.

In some cases, for example, taxpayers "zero out" a GRAT by structuring the trust so that the value of the annuity interest under section 7520 equals (or nearly equals) the entire value of the property transferred to the trust. Under this strategy, the value of the remainder interest (which is computed by subtracting the value of the annuity as determined under section 7520 from the value of the property transferred to the trust) − and hence the value of any gift that is subject to gift taxation − is deemed to be equal to or near zero. In reality, however, taxpayers often achieve returns on trust assets substantially in excess of the returns assumed under section 7520. Any such excess appreciation generally passes to the remainder beneficiaries without further transfer tax consequences.

Furthermore, the grantor may risk little under present law by funding a "zeroed out" GRAT with an aggressive portfolio, even where the trust assets do not perform well. If the trust yield merely equals the statutorily assumed return on trust assets, the trust principal will be

[1249] Sec. 2036.

returned to the grantor in the form of annuity payments. If the trust yield is less than the required annuity payments, the trustee will invade the principal of the trust, and the grantor will receive in satisfaction of his annuity interest the same property (e.g., securities or other income producing assets) used to fund the trust.[1250] In either case, although the grantor has failed to achieve a low- or no-gift tax transfer to remainder beneficiaries, the grantor has lost only the use of capital during the term of the trust.

Grantors often structure GRATs with relatively short terms, such as two years, to minimize the time that the assets are unavailable to the grantor and the risk that the grantor will die during the trust term, causing all or part of the trust assets to be included in the grantor's estate for estate tax purposes. Because GRATs carry little down-side risk, grantors frequently maintain multiple short-term, zeroed-out GRATs funded with different asset portfolios to improve the grantor's odds that at least one trust will outperform significantly the section 7520 rate assumptions and thereby allow the grantor to achieve a transfer to the remainder beneficiaries at little or no gift tax cost.

The budget proposal is designed to introduce additional down-side risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. Relative to shorter-term (e.g., two-year) GRATs, a GRAT with a 10-year term would tie up the assets transferred to the GRAT for a longer term and would carry greater risk that the grantor would die during the trust term and that the trust assets would be included in the grantor's estate for estate tax purposes.[1251]

The proposal would eliminate the use of shorter-term GRATs (i.e., GRATs with terms of less than 10 years) for gift tax avoidance. It is likely, however, that some taxpayers would continue to use GRATs with terms of 10 or more years as a gift tax avoidance tool. Even in the absence of a statutory minimum term, the use of a longer-term GRAT may be more desirable than using successive shorter term GRATs in certain circumstances, such as where the section 7520 rate is expected to increase over time. In this situation, use of a longer-term GRAT would allow the grantor to lock in the lower rate for the entire trust term. The proposal arguably would do little to curb the use of GRATs in such cases.

The proposal would not prevent the "zeroing-out" of a GRAT's remainder interest for gift tax purposes or the funding of GRATs with an aggressive portfolio. Instead, the proposal introduces downside risk only by increasing the likelihood that a grantor will die during the trust term. Wealthy younger taxpayers may view the likelihood of dying during a 10-year trust term as remote and thus may be willing to establish one or more 10-year GRATs in an effort to avoid gift tax. The proposal might therefore have the effect of encouraging taxpayers to establish

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[1250] Where the grantor is treated as owner of the trust, the distribution to the grantor generally will not be treated as a recognition event. See Rev. Rul. 85-13, 1985-1 C.B. 184.

[1251] The proposal also requires that the remainder interest of a GRAT have a fair market value greater than zero and prohibits a reduction in the annuity during the GRAT term. These requirements are designed to prohibit circumvention of the ten-year minimum term requirement of the proposal.

GRATs earlier in life. Long-term GRATs likely would be less attractive to taxpayers who achieve wealth only at a more advanced age.

Some might argue that a better approach would be one that achieves a more accurate valuation of the gift portion of a GRAT for gift tax purposes. This could be achieved, for example, by deferring the valuation of the remainder interest until it is distributed. Valuing the actual assets that will pass to the remainder beneficiaries at the time of the distribution, and basing the amount of the grantor's gift tax on such valuation, largely would eliminate opportunities to use a GRAT to leverage a gift tax exemption or, in the case of a "zeroed out" trust, to pass assets to heirs free of gift tax. On the other hand, some might argue that such an approach would introduce uncertainty into transfer tax planning. For example, in certain instances a grantor may not be able to predict the extent of appreciation of trust assets that will occur during the annuity term. This lack of certainty, one might argue, could result in unexpected taxable gifts by the grantor, and the grantor may have insufficient liquid assets to pay an unexpected gift tax when due.[1252] Deferring valuation of the remainder interest also might create administrative challenges for the IRS; although a gift tax return is filed for the year in which assets are transferred to the trust, the value for gift tax purposes would not be determined until the interest is distributed, which could occur many years later.

Prior Action

A similar proposal was included in the President's fiscal year 2010 budget proposal.

[1252] Such uncertainty could be addressed, however, though an election under which a grantor agrees to have trust assets invested only in certain less aggressive instruments likely to produce an average return not greater than the return assumed under section 7520. This would limit a grantor's ability to manipulate the GRAT valuation assumptions to pass assets to heirs free of gift tax.

VII. UPPER-INCOME TAX PROVISIONS

A. Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability

Present Law

General structure of the individual income tax

Under the Code, gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include, among other things, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to certain IRAs, one-half of self-employment taxes, certain moving expenses, and alimony payments.

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2010, the amount deductible for each personal exemption is $3,650. This amount is indexed annually for inflation. For 2010, the deduction for personal exemptions is not reduced or eliminated based on income. Prior to 2010, deductions for personal exemptions were reduced when income exceeded certain thresholds, which were adjusted annually for inflation. In 2009, those thresholds were $166,800 for single individuals, $250,200 for married individuals filing a joint return and surviving spouses, $199,950 for heads of households, and $125,100 for married individuals filing separate returns.

Standard and itemized deductions

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2009, the amount of the standard deduction is $5,700 for single individuals and married individuals filing separate returns, $8,400 for heads of households, and $11,400 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.[1253] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation. Finally, a taxpayer may reduce AGI by an additional standard deduction for State and local property taxes paid of $500 ($1,000 for joint filers) and for qualified motor vehicle taxes.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage

[1253] For 2009, the additional amount was $1,100 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households was $1,400. If an individual is both blind and aged, the individual was entitled to two additional standard deductions, for a total additional amount (for 2009) of $2,200 or $2,800, as applicable.

interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), casualty and theft losses (in excess of $500 per loss and in excess of 10 percent of AGI), and certain miscellaneous expenses (in excess of two percent of AGI).

For 2009, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was reduced by three percent of the amount of the taxpayer's AGI in excess of $166,800 ($83,400 for married couples filing separate returns). These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present law limitations applicable to such deductions (such as the separate floors) are applied first, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. Under prior law, the otherwise allowable itemized deductions may not be reduced by more than 80 percent. The overall reduction in itemized deductions was phased down to 1/3 of the full reduction amount in 2009. In 2010, the phase-out of itemized deductions does not apply. However, the limitation on itemized deductions is fully effective again in 2011 and thereafter as a result of the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") sunset provision.

Individual income tax rates

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply. Lower rates apply for long-term capital gains; those rates apply for both the regular tax and the alternative minimum tax.

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2009, the regular individual income tax rate schedules are listed earlier in section III.C of this document.

Alternative minimum tax liability

An alternative minimum tax ("AMT") is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are also used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's "tax preference items" and adjusted by redetermining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2010 are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; (3) $22,500 in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions items, are not allowed to reduce AMTI.

Description of Proposal

The proposal would limit the rate at which taxpayers with taxable income in excess of a threshold amount benefit from itemized deductions. In general, the proposal would limit the benefit of itemized deductions for individuals to 28 percent of the amount of the deductions. The proposal would apply to itemized deductions after they have been reduced under a separate fiscal year 2010 budget proposal that would reinstate the pre-EGTRRA limitation on certain itemized deductions, but with adjusted AGI thresholds in 2011 of $250,000 (indexed for inflation from 2009) for married taxpayers filing jointly and $200,000 (indexed for inflation from 2009) for other taxpayers. After 2011, these thresholds would be indexed for inflation.

Example 1: Taxpayer subject to regular income tax

Assume that a taxpayer in the 36-percent income tax bracket for 2011 makes a $10,000 charitable contribution. Under present law, the $10,000 contribution will result in a $3,600 tax savings, or 36 percent of $10,000 (disregarding any other limitations that may apply to reduce the taxpayer's itemized deductions). Under the proposal, the same $10,000 contribution by the same 36-percent bracket taxpayer would result in a tax savings of only $2,800 (28 percent of $10,000), thus raising his tax liability by $800 (or eight percent (36 percent minus 28 percent) of his $10,000 contribution).

Example 2: Taxpayer subject to alternative minimum tax

The proposal would have two effects on taxpayers subject to the AMT. However, these effects apply only if the taxpayer is first subject to any reduction in his regular tax liability−that is, if his marginal statutory regular tax rate is in excess of 28 percent.

Under the first effect, the proposal increases the taxpayer's tentative minimum tax liability by a fraction of the increase in regular tax liability caused by the limitation. The fraction is equal to the proportion of non-preference item itemized deductions to total itemized deductions. Thus, in the example above, assume the taxpayer had $20,000 in State and local taxes, an itemized deduction that is a preference item for purposes of the AMT, in addition to his $10,000 charitable deduction (a non-preference item), for a total of $30,000 of itemized deductions. Under the regular tax, the taxpayer will have his tax liability increased by eight percent (36 percent minus 28 percent) of $30,000, or $2,400. The taxpayer's tentative minimum tax liability is increased by $2,400 times the fraction of non-preference to total itemized deductions ($10,000/$30,000, or 1/3), or $800.

The second effect is triggered if the taxpayer's AMTI is in the range that makes him subject to the phase-out of the AMT exemption amount. In this situation, the taxpayer is subject to an additional increase in his tentative minimum tax liability. The additional increase is equal to the amount by which the value of the non-preference itemized deductions exceeds 28 percent of the deduction. For example, if the taxpayer is in the 28 percent marginal rate bracket of the AMT, but is also subject to the phase-out of the AMT exemption amount, a non-preference itemized deduction reduces his AMT liability in two ways under present law. First, the direct effect is that the deduction lowers AMTI by the amount of the deduction, reducing the tax liability by 28 percent of the deduction amount. Second, in reducing AMTI directly, the deduction reduces the phase-out of the AMT exemption amount by 25 percent of the deduction amount. Thus, the combined effect of the deduction under present law is to reduce AMTI by 125 percent of the deduction, which, for the 28 percent ratepayer, reduces AMT liability by 125 percent of 28 percent, or 35 percent of the deduction amount. Under the proposal, the value of the deduction would be limited to 28 percent of the deduction amount, thus a taxpayer subject to the AMT exemption amount phase-out will face a further increase in his AMT liability, in this case equaling seven percent of the deduction amount.[1254] For the taxpayer described above with $10,000 of non-preference deductions, the taxpayer's tentative minimum tax liability would be increased a further $700 (seven percent of $10,000).

Effective date.−The proposal is effective for tax years beginning after December 31, 2010.

Analysis

In general

This proposal has been the subject of considerable debate. Although the proposal applies broadly to all itemized deductions, much of the debate centers on the likely effect of the proposal on charitable giving and housing (discussed below). Some proponents have argued that limiting the benefit of itemized deductions in this manner will reduce the incentive to undertake certain activities. To the extent that certain deductions, such as those for medical expenses, casualty or theft losses, or local taxes, are designed to more accurately reflect a taxpayer's ability to pay,

[1254] In the case of a taxpayer subject to the AMT exemption phaseout but in the statutory 26 percent AMT rate bracket, the value of a non-preference item is 125 percent of 26 percent, or 32.5 percent. Such taxpayer will face an increase in their AMT liability of 4.5 percent (32.5-28) of the amount of the deduction by this second effect of the proposal.

opponents argue that no adjustment should be made to the deductions, and any concern about fairness or progressivity should be addressed through the marginal tax rate structure.

Alternative minimum tax

The proposal impacts taxpayers subject to the AMT more substantially than taxpayers not subject to the AMT. Specifically, the proposal reduces the value of the taxpayer's itemized deductions to an amount less than 28 percent, as a result of the two effects described in example 2 above. In that example, because the taxpayer's aggregate liability is determined by the AMT (since that yields a higher tax than the regular tax), the taxpayer's regular tax liability is not relevant as it is below his AMT liability.[1255] Under the proposal, notwithstanding that the taxpayer is subject to the AMT, an additional increase in AMT liability is imposed based on the regular tax computation even though that computation ordinarily would have no bearing on AMT liability. In the example, under present law the taxpayer will receive a $3,500 tax benefit from his $10,000 charitable contribution, composed of the deduction against the 28 percent marginal AMT rate (yielding $2,800) and the reduction in the amount of the phaseout of the exemption amount (25 percent of 10,000 = $2,500), whose value at the 28 percent rate is 28 percent of $2,500, or $700. Under the proposal, the taxpayer loses this $700 benefit related to the phaseout of the exemption amount, and is also subject to the $800 increase in tax based on the first of the AMT effects described above (related to the reduction in the value of the itemized deductions as calculated for the regular tax). On net, the taxpayer receives only a $2,000 benefit for the $10,000 deduction. Thus, the value of his charitable deduction is held to 20 percent, not 28 percent.[1256]

It is not clear on what policy grounds the proposal imposes the first of these effects on AMT taxpayers, as the second effect is sufficient to limit the value of the deductions to 28 percent of the deduction. By imposing an additional tax liability on AMT taxpayers based on an increase in their regular tax that still leaves their regular tax liability below their AMT liability is a departure from the normal relationship between the regular tax and the AMT. Under the normal relationship between the AMT and the regular tax, any increase in one's regular tax liability that occurs as result of any provision of the Code will increase one's overall tax liability only if regular tax liability exceeds AMT liability.

[1255] While technically a taxpayer's AMT liability is tax imposed in addition to regular tax liability, the term "AMT liability" is used in this discussion, for ease of exposition, to refer to the aggregate tax liability of a taxpayer affected by the AMT.

[1256] In the event that the taxpayer were in the 39.6 percent regular tax bracket but subject to the AMT as well as the phaseout of the AMT exemption amount, the $10,000 charitable deduction will trigger an increase in the AMT of $1,160 by the first effect (39.6 percent - 28 percent multiplied by $10,000), and a further $700 by the second effect as described above, yielding a deduction value of only $1,640 ($3,500 - $1,160 -$700). Such taxpayer's charitable contribution deductions are thus limited to 16.4 percent of the deduction amount, rather than the proposal's asserted 28 percent.

Charitable deduction

Some argue that the proposed limitation on itemized deductions diminishes a taxpayer's incentive to make charitable contributions by increasing the after-tax cost of charitable giving.[1257] Additionally, the reduction in after-tax income resulting from the proposal will mean that taxpayers have less disposable income to spend on all goods, including charity. These commentators argue that the proposal will result in a decrease in charitable giving as a result of both the increased after-tax cost of charitable giving and the reduction in after-tax income.[1258] With respect to the altered after-tax cost of giving, for example, under present law a 39.6-percent bracket taxpayer who makes a $1,000 charitable contribution (disregarding any other limitations that may apply to limit itemized deductions) will save $396 in Federal income tax (39.6 percent of $1,000). In other words, the after-tax cost to the taxpayer is only $604 to give $1,000 to charity ($1,000 - $396 savings). Under the proposal, that $1,000 charitable contribution will cost the same taxpayer $720 ($1,000 - (28 percent of $1,000)). This represents a cost increase of more than 19 percent.

Others, however, argue that the proposed limit will result in little if any reduction in overall charitable giving.[1259] Some argue, for example, that charitable giving is motivated in significant part by factors other than tax rules, such as altruism and the overall state of the economy;[1260] most taxpayers, therefore will not eliminate or significantly reduce charitable giving under the proposal. Indeed, under the proposal, each additional dollar given to charity by a taxpayer subject to the proposal will continue to result in a tax savings, although at a rate of 28 percent rather than the higher 36 or 39.6-percent rates.

[1257] For a recent literature review of the responsiveness of charitable giving to its price, see John Peloza and Piers Steele, "The Price Elasticities of Charitable Contributions: A Meta Analysis," *Journal of Public Policy & Marketing* 24: 260-272, 2005. See also Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; and Jon Bakija and Bradley Heim "How Does Charitable Giving Respond To Incentives And Income? Dynamic Panel Estimates Accounting For Predictable Changes In Taxation," National Bureau of Economic Research Working Paper 14237, August 2008.

[1258] See Independent Sector, Statement on Changes to Tax Incentives for Charitable Giving and Health Care Reform, *http://www.independentsector.org/media/20090326_giving_healthcare_statement.html* (March 26, 2009) (arguing that changes in tax benefits affect charitable giving levels and that the President's budget proposal will result in a decrease in charitable giving).

[1259] For example, the Center on Philanthropy at Indiana University performed a study to determine how the President's proposal would affect charitable giving. See The Center on Philanthropy at Indiana University, White Paper, "How Changes in Tax Rates Might Affect Itemized Charitable Deductions," *available at* http://www.philanthropy.iupui.edu/docs/2009/2009_TaxChangeProposal_WhitePaper.pdf (March 2009) (hereafter "Indiana University White Paper"). Using a simplified model and 2006 itemized deduction data, the Center estimated that, if the budget proposal had been in effect in 2006, "the impact on itemized giving would have been a relatively small reduction when measured as a percentage of total itemized charitable giving by individuals (a decrease of 2.1 percent)." Looking only at the highest income households, the Center estimated a slightly larger drop (approximately 4.8 percent). The Center concluded that "[t]he larger economy plays a more important role in changes in giving than do tax rate changes."

[1260] See, e.g., Indiana University White Paper, *supra*.

Furthermore, some argue that the proposal improves fairness and equity to the tax treatment of itemized deductions by partially leveling the tax benefit to higher- and lower-income taxpayers resulting from identical gifts. For example, assume that a taxpayer in the 36-percent bracket and a taxpayer in the 25-percent bracket each make identical $1,000 contributions to charity. As a result of the $1,000 contribution, the higher-income taxpayer will have a tax savings of $360 (36 percent of $1,000), such that his cost of making the $1,000 contribution is $640 ($1,000 - $360). The taxpayer in the 25-percent bracket, however, will achieve a tax savings of only $250 (25 percent of $1,000), such that his cost of making the $1,000 contribution is $750 ($1,000 - $250). In other words, under present law, an identical charitable contribution results in a greater tax benefit (in this example, $110) to the higher-bracket taxpayer, even though the lower-bracket taxpayer arguably has been more generous by contributing a higher percentage of his taxable income to charity. The proposal limits (but does not eliminate) this disparate treatment by limiting the rate at which the higher-bracket taxpayer may benefit from itemized deductions to 28 percent.[1261]

On the other hand, such a fairness argument rests on an implicit assumption that, when a taxpayer makes a charitable contribution, he or she is buying something that yields personal gain. If, however, one's initial view is that a gift to charity reduces a taxpayer's resources available for private consumption, then the proposed modification to the marginal rates at which taxpayers may benefit from deductions should not be undertaken. Under this view, a taxpayer with a $110,000 in income who gives $10,000 to charity is in the same economic position as someone who earns $100,000 and donates nothing to charity, and thus the full deduction should be allowed at the taxpayer's statutory marginal tax rate. Otherwise, taxpayers similarly situated with respect to resources available for private consumption would face differential tax burdens.

Mortgage interest and property tax deductions

The deductions for home mortgage interest and property taxes reduce the after-tax cost of financing and maintaining a home. The benefit for any given dollar amount of deduction rises as the marginal tax rate of the taxpayer rises. However, research suggests that the aggregate benefits of the home mortgage interest deduction, and thus the costs of any limitation, are distributed heterogeneously among taxpayers, even among those with more than $250,000 in income.[1262] Within this group, as within any group, the largest benefits accrue to younger homeowners, who tend to have higher loan-to-value ratios, and to those taxpayers purchasing more expensive homes.

Limiting itemized deductions will raise the after-tax cost of financing and maintaining a home for affected taxpayers. One study estimates that completely repealing the mortgage

[1261] Note that this disparate treatment would not exist if all taxpayers faced the same marginal tax rate. In other words, the disparate treatment is the combined effect of the deduction and a progressive rate (or any non single rate) structure.

[1262] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96, May 2008.

interest deduction will raise the cost of capital for owner-occupied housing by seven percent.[1263] Smaller cost increases are associated with limiting the deduction. However, if in response to limiting the mortgage interest deduction, taxpayers adjusted their portfolios by liquidating non-housing assets to reduce their mortgage debt, changing the tax treatment of mortgage interest might have little impact on the cost of capital for owner-occupied housing.[1264] As with the benefits of the deduction, the largest increases in the cost of housing will occur for younger, high-income homeowners with relatively higher loan-to-value ratios and relatively fewer non-housing assets with which to reduce those ratios. Under general economic principles, demand for housing by affected taxpayers would be expected to decline in response to the increased cost.

Some argue that the proposal will have a detrimental effect on the U.S. economy, because it will lead to a decline in home prices at a time when many homeowners have already seen the value of their residences decline to an amount below their mortgage balances. Areas with relatively large numbers of affected taxpayers and relatively inelastic housing supply will be expected to face the greatest price declines. This, they argue, could lead to deterioration in bank balance sheets as the value of their mortgage loans and mortgage-backed securities also decline.

Others argue that limiting the home mortgage interest deduction is unlikely to have a detrimental effect on the U.S. economy. They argue that the limitation will affect too few taxpayers to reduce incentives for the marginal homebuyer, and thus home prices would not likely decline. Still others question whether the mortgage interest deduction even serves its intended purpose of encouraging homeownership and the positive spillover benefits presumed to entail.[1265] On the contrary, proponents argue that, to the extent that the mortgage interest deduction creates economic distortions − increasing the size and cost of housing, increasing the allocation of capital to owner-occupied housing away from potentially higher pre-tax return investments in other sectors, increasing the amount of leverage used to purchase homes − limiting the deduction could be beneficial to the economy as a whole by minimizing such distortions.

Prior Action

A similar provision was included in the President's fiscal year 2010 budget proposal.

[1263] *Ibid.*

[1264] See Martin Gervais and Manish Pandey, "Who Cares about Mortgage Interest Deductibility?" *Canadian Public Policy,* vol. 34, March 2008, available at http://www.economics.soton.ac.uk/staff/gervais/publications/gervais_pandey_cpp_2008.pdf. Wealthier households are more likely to alter their balance sheets to reduce their loan-to-value ratios. To the extent that non-housing assets generate income subject to tax, such portfolio shifting will reduce taxable income for these households, partially offsetting the increase in tax due to limitation of the deduction. Also, the benefits of deductibility do not increase with income as fast as taxes paid. Accordingly, Gervais and Pandey (2008) find "mortgage interest deductibility makes the tax code less progressive at relatively low levels of income and more progressive for relatively high levels of income."

[1265] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction" in James M. Poterba (ed.), *Tax Policy and the Economy* 17, (Cambridge, Mass.: The MIT Press), 2003.

VIII. SUPPORT CAPITAL INVESTMENT IN THE INLAND WATERWAYS

Present Law

The Code imposes a tax of 20 cents per gallon on fuel used in a vessel in commercial waterway transportation to fund the Inland Waterways Trust Fund.[1266] Commercial waterway transportation means any use of a vessel on any inland or intracoastal waterway of the United States in the business of transporting property for compensation or hire, or in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage).

The Code provides several exemptions from the tax. The tax does not apply to fuel for vessels primarily used for passenger transportation. Nor does it apply to fuel used in deep-draft ocean-going vessels. Additional exemptions are provided for fuels used by State and local governments in transporting property in governmental business and for fuels used by tugs moving LASH (lighter-aboard-ships) and seabee oceangoing barges released by their oceangoing carriers solely to pick up or deliver international cargoes.

In addition to tax revenues, the Inland Waterways Trust Fund also earns investment interest on its unexpended balances. In fiscal year 2009, $76.0 million was collected from the inland waterway fuel tax and the trust fund earned $0.4 million in interest.[1267] At the end of fiscal year 2009, the trust fund had a balance of $57.7 million. However, the balance available for new obligations is $14.3 million.[1268]

The Army Corps of Engineers is responsible for the construction, operation and maintenance of inland waterway infrastructure. Present law allows up to 50 percent of the cost of construction projects to be funded by the Inland Waterway Trust Fund, the remainder to be funded from general revenues.

Description of Proposal

The tax on liquids used as a fuel in a vessel in commercial waterway transportation is phased out and replaced by a fee system based on lock usage. The tax rate is reduced to 10 cents per gallon beginning January 1, 2013. The tax is repealed for periods after December 31, 2014. The fee system based on lock usage is phased in beginning on October 1, 2011. For calendar year 2015 and each subsequent calendar year, the fee schedule would be adjusted as necessary to maintain an appropriate level of net assets in the Inland Waterways Trust Fund.

[1266] Sec. 4042(b) and sec. 9506. In addition to the 20-cents-per-gallon Inland Waterways Trust Fund financing rate, such fuel is also subject to a tax of 0.1-cent-per-gallon to fund the Leaking Underground Storage Tank Trust Fund.

[1267] Inland Waterways Users Board, Inland Waterways Trust Fund Status Report, December 15, 2009, available at: http://www.iwr.usace.army.mil/usersboard/IWTF%20Status%20Dec%2009.pdf.

[1268] *Ibid*.

Effective date.−The proposal is effective on the date of enactment.

Analysis

The nation's waterway infrastructure is aging and there will be an increasing need to replace it. Many locks are over 50 years old and have outlived their original engineered life.[1269] This will require additional funds. The President's budget proposal seeks to raise these additional funds through the imposition of a user fee in lieu of the present inland waterway tax.

Proponents of the proposal argue that the excise tax does not raise enough revenue to pay for the construction and rehabilitation of the locks and dams on the inland and intracoastal waterways. Some argue that instead of imposing a new fee, the excise tax rate could be increased to provide the necessary funding. However, it has been argued that the excise tax is an inefficient method for raising the necessary funds and that user fees should be imposed on the basis of the costs of the projects. Proponents argue a fee based on the cost to improve a lock that is imposed on the user of such lock would be more equitable than a tax imposed on all users regardless of whether they will use the facilities since the beneficiaries of the construction project would be paying for its cost. It is not clear from the proposal whether the fees will be set according to each project or set based on an aggregate level of spending to be incurred for that fiscal year. If the same rate applies regardless of the facility being used, the arguments that a fee is more efficient and equitable than a tax are not as strong.

Some argue that a fee structure allows for more flexibility than a tax, allowing the fees to be increased when needed to meet construction needs and reduced when that level of spending is no longer needed. Adjusting the tax would require action by Congress. A user fee also could reduce congestion on the waterways as some look for alternate means of transportation to avoid the fee.

Others argue that the insufficient trust fund balance is a result of project cost overruns and seriously delayed construction pace. They note that the highest priority projects are expected to take 20 years or more to complete, meaning that current payors into the trust fund will realize no benefits until far into the future. Opponents of the new fees argue that until the project management issues can be resolved to provide more timely and cost effective benefits, increased funding should not be provided to continue an inefficient system.

An increased fee or tax increase specific to a construction project in that area could negatively affect commerce in that area. In some cases, basing the fee on costs could result in dramatic increases as the costs of certain projects may far exceed others. For example, the average four-barge tow on the Columbia-Snake River System pays about $684 in diesel taxes, one way. Under similar lock usage proposal proposed by the Bush Administration, a four-barge tow that transits all eight locks on the Columbia Snake River System would incur a fee of $2,560

[1269] Inland Waterways Users Board, *22nd Annual Report to the Secretary of the Army and the United States Congress,* May 2008, at 1.

each way.[1270] Opponents argue that such increases could cause the diversion of cargo to more polluting methods of transportation.[1271] They argue that barge transportation surpasses truck and rail transportation in terms of safety, fuel efficiency, emissions and congestion impacts.[1272] Thus, the proposal, in the view of its opponents, would penalize the more efficient mode of transportation.

Opponents argue that the fuel tax is more equitable than the lock usage fee as a method of supporting the Inland Waterways Trust Fund. They note that the inland waterways system confers national benefits, however only those that transit through the locks would be subject to the new fees required to pay for the system. On the other hand, general revenues are contributed toward 50 percent of the construction costs, which arguably represents the national benefit and some would argue that the new lock usage fee is to bring user support more in line with the benefits derived from the inland waterway system.

Prior Action

A similar proposal was included in the President's fiscal year 2009 and 2010 budget proposals.

[1270] Pacific Northwest Waterways Association, Nor'wester, Issue 302, *Administration Releases Details of Proposed Lockage Fee for Inland Waterways* (April 11, 2008) available at: http://www.pna.net/new/Norwester_Articles/Norwester_302.htm.

[1271] Stephen D. Little, *Statement of Stephen D. Little on behalf of Waterways Counsel Inc., Before the Subcommittee on Water Resources and Environment, Committee on Public Works and Transportation, U.S. House of Representatives* (April 30, 2008) at 3.

[1272] Inland Waterways Users Board, *22nd Annual Report to the Secretary of the Army and the United States Congress* (May 2008) at 3, *citing* Center for Ports and Waterways, Texas Transportation Institute, *A Modal Comparison of Domestic Freight Transportation Effects on the General Public* (December 2007).

IX. OTHER INITIATIVES

A. Extend and Modify the New Markets Tax Credit

Present Law

In general

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[1273] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years.[1274] The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.[1275] The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed.[1276]

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities through their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE.[1277] A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder.[1278] Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any

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[1273] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (December 21, 2000).

[1274] Sec. 45D(a)(2).

[1275] Sec. 45D(a)(3).

[1276] Sec. 45D(g).

[1277] Sec. 45D(c).

[1278] Sec. 45D(b).

loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.[1279]

A "low-income community" is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income.[1280] For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary is authorized to designate "targeted populations" as low-income communities for purposes of the new markets tax credit.[1281] For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994[1282] (the "Act") to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.[1283] A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391 of the Code, and is contiguous to one or more low-income communities.

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

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[1279] Sec. 45D(d).

[1280] Sec. 45D(e).

[1281] Sec. 45D(e)(2).

[1282] Pub. L. No. 103-325.

[1283] Pub. L. No. 103-325.

percent of the average of the aggregate unadjusted bases of the property of the business is attributable to certain financial property or to certain collectibles.[1284]

The maximum annual amount of qualified equity investments was $5.0 billion for calendar years 2008 and 2009. The new markets tax credit expired on December 31, 2009.[1285]

Alternative minimum tax

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax.[1286] An individual's tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

The new markets tax credit cannot be used to offset AMT liability because business tax credits generally may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability in excess of $25,000).[1287] Credits not allowed may be carried back one year and carried over for up to 20 years.

Description of Proposal

The proposal extends the new markets tax credit for two years, with an allocation amount of $5.0 billion each year, and would make other improvements to the new markets tax credit that allows the new markets tax credit to be used to offset AMT liability.[1288]

Effective date.–The proposal is effective on the date of enactment.

[1284] Sec. 45D(d)(2).

[1285] The American Workers, State, and Business Relief Act of 2010 (H.R. 4213) as passed by the Senate on March 10, 2010 would extend the new markets tax credit for one year. The Tax Extenders Act of 2009 (H.R. 4213) as passed by the House of Representatives on December 09, 2009 would also extend the new markets tax credit for one year.

[1286] Sec. 55(a).

[1287] The Small Business and Infrastructure Jobs Tax Act of 2010 (H.R. 4849) as passed by the House on March 24, 2010 would allow the new markets tax credit to be used to offset AMT liability.

[1288] Treasury does not specify the "other improvements" to the new markets tax credit. *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010. However, Treasury has indicated that the improvements are to allow the new markets tax credit to be used to offset AMT liability. Under the proposal, a taxpayer's tentative minimum tax would be zero for purposes of determining the tax liability limitation with respect to the new markets tax credit.

Analysis

Extending the new markets tax credit

As of January 2010, Treasury has allocated all available new markets tax credits.[1289] From the first round of new markets tax credit allocations in 2003 through 2009, demand for the credit has exceeded available allocation authority by at least 4.5 times in each allocation round.[1290] The fact that the program was oversubscribed when credits per investment totaled 39 percent levels suggests that the credit may have been more generous than would be required to encourage new investment, and the credit rate could have been lowered while funding more projects on the same budget.

Proponents of extending the new markets tax credit point to the demand for the credit and argue that the credit has proved to be an effective means of providing equity and other investments to benefit businesses in low income communities. Moreover, they argue that investor interest in new markets tax credits has remained high despite the turmoil in the economy. Thus, they argue the credit should be extended for at least one additional year.[1291]

Others claim that a comprehensive review of the new markets tax credit program has not yet been performed so its effectiveness is unclear.[1292] Similarly, it is not clear whether the investment in low income communities represents new investment that would not have occurred in the absence of the program.[1293] To the extent the new markets tax credit is applied to investment that would have otherwise occurred, the impact of the credit is diminished. Those against extending the credit may note that corporate investors, which make the majority of

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[1289] A total of $26 billion in credits was allocated through December 31, 2009. As originally enacted in 2000, $15 billion was allocated for the new markets tax credit program through 2007. Pub. L. No. 106-554. In 2005, an additional $1 billion of credits was allocated for qualified areas affected by Hurricane Katrina over a period of 3 years. The Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135 (Dec. 21, 2005). In 2006 and again in 2008, another $3.5 billion was allocated. The Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 (Dec. 20, 2006), and the Tax Extenders and Alternative Minimum Tax Act of 2008, Pub. L. No. 110-343 (Oct. 3, 2008). In 2009, an additional $3 billion of credits was allocated to be split equally between the 2008 (retroactively) and 2009 allocations. The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (Feb. 17, 2009).

[1290] Government Accountability Office, *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified*, GAO-10-334, January 2010, p. 4.

[1291] The New Markets Tax Credit Coalition, *The New Markets Tax Credit: Progress Report 2009*, June 2009, p. 33-34 ("At a minimum, Congress should enact legislation…that not only extends the Credit for 5 years at $5 billion per year in Credit authority, but also provides [new markets tax credit] investors with AMT relief.")

[1292] A complete accounting of the new markets tax credit benefits has not yet been performed. In the meantime, the GAO has provided new markets tax credit reports to Congress in 2004, 2007, and 2010. The 2007 and 2010 reports are discussed above. In 2004, the GAO determined that progress was being made in implementing the new markets tax credit program and recommended that the IRS and the Treasury work together to monitor compliance. U.S. Government Accountability Office *New Markets Tax Credit Program: Progress Made in Implementation, but Further Actions Needed to Monitor Compliance*, GAO-04-326, January 2004.

[1293] Donald J. Marples, *New Markets Tax Credit: An Introduction*, CRS Report RL34402, March 16, 2010.

investments in CDEs, are shifting investment into low-income communities from higher income communities while individual investors as a group appear to be making at least some new investment to participate in the new markets tax credit program.[1294]

Similarly, those against extending the credit may argue that the complexity of new markets tax credit transaction structures makes it more difficult for CDEs to execute smaller transactions and results in less equity ending up in low-income community businesses than would likely end up there were the transaction structures simplified.[1295] In addition, current economic conditions may have contributed to lower prices that investors are willing to pay to purchase the right to claim the new markets tax credit, which also decreases the amount of equity available for low-income community businesses.

Allowing the new markets tax credit to offset AMT liability

Proponents of allowing new markets tax credit investments to offset AMT liability argue that this will broaden the pool of potential investors and put the new markets tax credit on par with other tax credits that can offset the AMT liability, such as the low-income housing tax credit and the historic rehabilitation tax credit.[1296] Additionally, the AMT liability offset may increase the amounts that investors are willing to pay for the new markets tax credit. These two benefits − an increase in the pool of investors and an increase in the price investors are willing to pay for the credit may have the beneficial effect of ensuring that a larger portion of the subsidy ended up in the qualified active low-income community business.

Others note that future new markets tax credit allocations may be reduced as Federal revenue losses increase to the extent that investors subject to the AMT who are not currently investing in new market tax credits become new market tax credit investors and claim credits that would otherwise go unclaimed.

Prior Action

A proposal to extend the new markets tax credit was not included in the President's fiscal year 2010 budget proposals. As noted, legislation passed by the Senate in March 2010 would extend the new markets tax credit for one year.[1297] Similar legislation passed by the House of

[1294] Government Accountability Office, *New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, But Opportunities Exist to Better Monitor Compliance*, GAO-07-296, January 2007, p. 4.

[1295] Government Accountability Office, *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified*, GAO-10-334, January 2010, p. 41.

[1296] The New Markets Tax Credit Coalition, *The New Markets Tax Credit: Progress Report 2009*, June 2009, p. 33-34

[1297] H.R. 4213 (The American Workers, State, and Business Relief Act of 2010), sec. 133, 111th Congress, (Engrossed Amendment as Agreed to by Senate on March 10, 2010).

Representatives in December 2009 would also extend the new markets tax credit for one year.[1298] In addition, legislation passed by the House in March 2010 would allow the new markets tax credit to be used to offset AMT liability.[1299]

[1298] H.R. 4213 (The Tax Extenders Act of 2009), sec. 203, 111th Congress, (Engrossed as Agreed to or Passed by House on December 9, 2009).

[1299] H.R. 4849 (The Small Business and Infrastructure Jobs Tax Act of 2010), sec. 206, 111th Congress, (Engrossed as Agreed to or Passed by House on March 24, 2010).

B. Reform and Extend Build America Bonds

Present Law

Build America Bonds

Section 54AA, added to the Code by the American Recovery and Reinvestment Act of 2009 ("ARRA"),[1300] permits an issuer to elect to have an otherwise tax-exempt bond, issued prior to January 1, 2011, treated as a "Build America Bond."[1301] In general, Build America Bonds are taxable governmental bonds, the interest on which is subsidized by the Federal government by means of a tax credit to the holder ("tax-credit Build America Bonds") or, in the case of certain qualified bonds, a direct payment to the issuer ("direct-pay Build America Bonds").

Definition and general requirements

A Build America Bond is any obligation (other than a private activity bond) if the interest on such obligation would be (but for section 54AA) excludable from gross income under section 103,[1302] and the issuer makes an irrevocable election to have the rules in section 54AA apply.[1303] 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.[1304] 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;[1305] the yield on a direct-pay Build America Bond is reduced by the payment made pursuant to section 6431.[1306] A Build America 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.[1307]

[1300] Pub. L. No. 111-5.

[1301] Sec. 54AA.

[1302] 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).

[1303] 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.

[1304] 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.

[1305] Sec. 54AA(d)(2)(B).

[1306] Sec. 6431(c).

[1307] Sec. 54AA(d)(2)(C).

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.[1308] 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.[1309] The sum of the accrued credits is allowed against regular and alternative minimum tax; unused credit may be carried forward to succeeding taxable years.[1310] 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.[1311] 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.[1312]

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.[1313] 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.[1314] 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).[1315] Direct-pay Build

[1308] 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)).

[1309] Sec. 54AA(e).

[1310] Sec. 54AA(c).

[1311] Sec. 54AA(f). See Notice 2010-28, *Stripping Transactions for Qualified Tax Credit Bonds* (March 23, 2010).

[1312] *Ibid.*

[1313] Sec. 54AA(g)(1). OID is not treated as a payment of interest for purposes of calculating the refundable credit under the provision.

[1314] Sec. 54AA(g).

[1315] 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.[1316]

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.[1317] In lieu of payment to the issuer, the payment may be made to a person making interest payments on behalf of the issuer.[1318]

Description of Proposal

The proposal makes the direct-pay Build America Bonds program permanent at a Federal subsidy level equal to 28 percent of the coupon interest on the bonds.

The proposal also expands the eligible uses for Build America Bonds to include the following: (1) original financing for governmental capital projects, as under the initial authorization of Build America Bonds; (2) current refundings of prior public capital project financings for interest cost savings where the prior bonds are repaid promptly within ninety days of issuance of the current refunding bonds; (3) short-term governmental working capital financings for governmental operating expenses (such as tax and revenue anticipation borrowings for seasonal cash flow deficits), subject to a thirteen-month maturity limitation; and (4) financing for Section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities.

Effective date.−The proposal is effective as of January 1, 2011.

Analysis

In general

A recent Treasury report indicates that BABs have been used in 48 States for $90 billion in direct-pay Build American Bond ("BAB") financing of capital projects.[1319] BABs were intended to assist State and local governments during the recent fiscal crisis by lowering borrowing costs and encouraging job growth by providing additional method of finance for the building of capital projects. During 2008, as the financial problems worsened, investors sought the safety of U.S. Treasury bonds. The pool of investors for tax-exempt debt declined, and State and local governments had to offer higher interest rates to attract buyers for their bonds. As a result, State and local governments faced an environment of sharply increasing borrowing costs.

[1316] 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.

[1317] Sec. 6431.

[1318] Sec. 6431(b).

[1319] U.S. Treasury Department, *Treasury Analysis of Build America Bonds and Issuer Net Borrowing Costs* (April 2, 2010) at 2.

BABs address the borrowing-cost issues by providing a Federal subsidy of interest payments lessening the out-of-pocket costs for State and local governments,[1320] and by broadening the pool of municipal bond investors to low tax and zero tax liability investors that normally would not hold tax-exempt debt. BAB issuers receive a subsidy of 35 percent of the interest paid to buyers of the bonds. This permits the issuers to pay interest rates that are competitive with rates paid on taxable debt by corporations and the Federal government. As a result, BABs have expanded the categories of municipal investors to those buyers such as pension funds and foreign entities without tax liability. Most BABs have been issued with long maturities, which makes the bonds attractive to investors looking for a stable, long-term, high rate of income and those trying to match income with their long-term obligations, such as pension funds.

Initially, issuers of long-term BABs obtained financing, after the application of the Federal subsidy, that was significantly less expensive than comparable tax-exempt debt. For example, California issued 30-year BABs at an interest rate of 7.4 percent, but after taking into account the Federal subsidy, subsidy California only has to pay net interest at 4.8 percent.

Over time, as the market for State and local debt adjusted to the new instrument, BABs and tax exempt bond interest rates began to converge as tax exempt bond interest rates began to fall. One reason for the fall in tax exempt bond interest rates was the increase in competition for municipal debt that traditional tax exempt bond investors faced from BAB investors. The higher marginal tax rate tax exempt bond investors would be willing to forego part of the subsidy that normally accrues to the investor in order to compete with the BAB investors. Therefore, a secondary effect of the BABs program is that some of the benefit that used to accrue to the investor in tax exempt bonds now accrues to the State and local government in the form of lower tax exempt bond interest rates.

Permanence

The President's budget proposal would make the direct-pay BAB program permanent, but at a lower rate. If the program expires as scheduled, it may make BABs a less liquid asset in the future. And while issuers would still have access to tax-exempt financing, some argue that such financing would be at higher rates in the absence of BABs. Some have attributed the new and temporary nature of BABs to the existence of higher BAB interest rates than comparable corporate debt, and higher fees (e.g., underwriting fees) paid by issuers when compared with tax-exempt debt. Some would argue that permanence would strengthen the market for these bonds and permit them to be issued at lower interest rates and with lower associated fees.

As a new financial product, issuers and investors have to devote substantial resources to learn and understand the program. Market participants are more likely to devote resources necessary for issuer and investor education if the program is permanent than if there is uncertainty about the long-term prospects of a program that sunsets after two years. In addition,

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[1320] In addition to reducing the out-of-pocket costs to State and local governments, the Federal subsidy may offer a measure of security for the investor as a portion of the interest is covered by the Federal government, thus encouraging the purchase of these bonds.

a permanent program may alleviate some of the uncertainty associated with a program that is continually extended, and, as such, receives periodic reevaluation that may result in substantial changes to the form of the program.

Opponents of the proposal would argue that the purpose of the BAB program was to provide temporary help to State and local governments during a period of financial crisis and therefore, the program should not be permanent.

Some may be concerned about a permanent program's effect on the Federal deficit. Although the program expires January 1, 2011, the Federal government's obligation to subsidize the interest payments continues for the life of the bonds. The program is without volume limitations and most BAB issuances have been for the long-term, e.g., 20 to 30 years, thus committing the Federal government to significant costs for decades outside the 10-year budget window. Unlike spending programs that are generally part of an annual appropriations process, the outlays for the BAB program are treated as tax refunds which are outside the annual appropriations process.

Finally, some have questioned the fiscal health of municipalities. This raises the issue of whether it is appropriate for the Federal government to encourage more State and local spending through BABs and other special bond programs, which may exacerbate the fiscal problems of certain municipalities.

Reducing the 35-percent subsidy

At 35 percent, the BAB subsidy is significantly deeper than that provided by tax-exempt debt. The President' budget proposal would reduce the Federal subsidy from 35 percent of interest paid to 28 percent of interest paid.

For policy purposes, comparing the subsidy level of a BAB to the subsidy of a traditional tax-exempt bond requires a comparison of the after-subsidy BAB interest rate to the tax-exempt bond rate that the issuer would face in the absence of the BAB program. During 2008 the average yield on BABs was approximately 6.175 percent. For illustration purposes, assuming a similar pricing environment in the future the after-subsidy yield on BABs at the 28 percent credit rate proposed in the President's budget would be 4.45 percent. Between the years 2000 to 2007 the interest rate on municipal bonds was, on average, 79 percent of the interest rate on comparable corporate debt. Assuming a similar relationship in the future implies tax-exempt interest rates of 4.89 percent, which suggests that BABs provide an interest cost savings of approximately nine percent over tax-exempt bonds. While forecasting these relationships in the future is speculative, using data on the historical relationships between taxable and tax-exempt debt suggest that BABs at the 28 percent credit rate still provide a deeper subsidy than comparable tax-exempt debt for at least some projects and, in particular, for long-term debt.

Expanded purposes

The President's budget proposal would allow refundings of BABs, ostensibly to achieve interest savings. Some investors were concerned about future changes in the program. That concern, combined with the general concerns associated with any new program, made some issuers provide "make whole" provisions. For some BABs these provisions require that the investor receive the full benefit of the bond if the bond is retired. Having to pay the full benefit of the prior bond, would seem to negate the savings of refundings. In addition, some have argued that callable bonds could be problematic for investors looking for a specific return.

The President's budget proposal would expand the permitted purposes beyond governmental capital projects, to include government working capital and projects for 501(c)(3) entities. These are purposes for which tax-exempt debt may be issued under present law, and so some argue that these expansions make BABs a more viable alternative to tax-exempt debt for State and local governments. Proponents argue that BABs are more efficient in delivering the Federal subsidy to the issuers than tax-exempt debt, and so this alternative should be further encouraged.

Because State and local government receipts from property and sales taxes often are uneven from month to month (due to seasonal or other timing issues), the governments issue tax-exempt debt to cover the temporary shortfall to cover operating expenses until the revenue is actually received. Some may argue that while there is a clear Federal interest in capital investment programs that could create jobs, and the Federal interest in providing an increased subsidy for the financing working capital is less clear. As noted above, the budget proposal would extend BABs to financing for section 501(c)(3) entities. Some might argue this is appropriate as such entities are performing functions that might otherwise have to be done by government, and thus are performing a quasi-governmental function. However, some might question whether there is a significant Federal interest in subsidizing the working capital expenditures of such organizations.

Prior Action

None.

C. Restructure Transportation Infrastructure Assistance to New York City

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[1321] The availability of these incentives for new investment activity has expired. The longest-lived incentive, a special depreciation allowance for qualified NYLZ property, is not available for property placed in service after December 31, 2009.

Description of Proposal

The proposal provides Federal tax credits to New York State and New York City for expenditures relating to construction or improvement of transportation infrastructure in or connecting to the NYLZ. The tax credits are allowed in each year from 2011 through 2020, inclusive, and are subject to an annual limit of $200 million, for a total of $2 billion in tax credits. They are divided evenly between New York State and New York City. Any amount of unused credit below the $200 million annual limit is carried forward to the following year, including years after 2020, and expenditures that exceed the $200 million annual limit are carried forward and subtracted from the $200 million annual limit in the following year.

The credits are allowable against any payment by the State or City to the Federal government required under a provision of the Internal Revenue Code other than the provisions relating to payments of excise taxes, FICA, SECA, or OASDI amounts. For example, the credits are allowable against payments of Federal income tax withheld with respect to State or City employees.

Treasury is authorized to prescribe guidance to ensure that the expenditures satisfy the intended purposes. The amount of the credit will be treated as State and local funds for purposes of any Federal program.

Effective date.−The proposal is effective on January 1, 2011.

Analysis

The proposal is based on the premise that some of the tax benefits provided by the expired NYLZ incentive provisions were not usable in the form in which they were originally

[1321] In addition to the NYLZ provisions described above, the following NYLZ provisions expired in 2006: five-year recovery period for depreciation of certain leasehold improvements, increase in expensing under Sec. 179, and extended replacement period for nonrecognition of gain under Sec. 1033.

provided, and that they should be succeeded by other benefits that would have a greater impact on the recovery and continued development in the NYLZ. The proposal reflects a preference for subsidizing transportation infrastructure as opposed to buildings and other private property.

The proposal could be criticized as disguising a Federal transportation infrastructure subsidy to New York State and New York City in the form of a tax credit. Providing a transportation infrastructure subsidy as a direct grant outside of the tax law would be more consistent with simplification of the tax law and administrative efficiency.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, 2008, 2009, and 2010 budget proposals. These prior proposals included the repeal of certain other NYLZ incentives not previously expired.

D. Implement Unemployment Insurance Integrity Legislation

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2 percent gross tax rate on the first $7,000 paid by covered employers to each employee during a calendar year. Employers in States with unemployment insurance programs approved by the Federal government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, resulting in a net FUTA tax rate of 0.8 percent. Because all States have approved programs, the FUTA tax rate that generally applies is 0.8 percent. Net Federal unemployment tax revenue funds a trust that finances the administration of: (1) the unemployment system, (2) half of the Federal-State extended benefits program, and (3) a Federal account from which States can borrow to pay unemployment benefits as needed. If the balance of the Federal Unemployment Trust Funds exceeds certain statutory ceilings, additional distributions ("Reed Act distributions") may be made to the States. States use Reed Act distributions to finance their regular State programs (which are mainly funded with State unemployment taxes) and the other half of the Federal-State extended benefits program.

State unemployment insurance taxes are deposited into a State's Federal unemployment insurance trust fund and are used by the State to pay unemployment benefits. State recoveries of overpayments of unemployment insurance benefits must also be deposited and used exclusively to pay unemployment benefits. States may enact penalties for overpayments, however, and amounts collected as penalties or interest on benefit overpayments may be treated as general receipts by the States.

Under present law, the IRS has the authority to credit Federal tax overpayments payable on or before September 30, 2018 against any other Federal tax liability owed by the person who made the overpayment. The balance of the overpayment is generally refunded, unless a claim has been made for payment of certain non-tax debts of that person, including certain unemployment compensation debts.[1322] Unemployment compensation debts subject to offset include those arising from uncollected contributions due to the State's Federal Unemployment Insurance Trust Fund that remain unpaid due to fraud and erroneous payments of unemployment compensation that were obtained by fraud on the part of the taxpayer who made the overpayment of tax, as well as the penalty and interest attributable to these debts. If the debt is for an erroneous payment, the State must establish that the debt has become final and certified by the Secretary of Labor.[1323] In addition, a State may only seek an offset for unemployment compensation debts owed by residents of the requesting State.[1324]

[1322] Sec. 6402(f) authorizes offsets of unemployment compensation debts against refunds payable for the ten year period beginning after September 30, 2008. Other non-Federal tax debts that may be claimed against overpayments of Federal tax liability include past-due support within the meaning of the Social Security Act, debts owed to Federal agencies and State income tax obligations. Sec. 602(c) - (e).

[1323] Sec. 6402(f)(5)(A).

[1324] Sec. 6402(f)(3).

Offsets for unemployment compensation and/or State income tax debts occur only after a taxpayer's overpayment has been reduced for any of the following debts, in the following order and before any amount is credited to estimated tax for a future Federal tax liability: (1) Federal tax debts, (2) past-due support within the meaning of the Social Security Act, and (3) debts owed to Federal agencies.[1325] If more than one unemployment compensation or State income tax debt is owed by the same resident to his State, the debts are satisfied by the overpayment in the order in which the debts accrued, without regard to whether they arise from State income tax or unemployment compensation. The actions of the IRS in reducing the overpayment to satisfy the foregoing debts are not subject to judicial review.[1326] In the event that a payment to a State is determined to have been made erroneously by the IRS in the exercise of its authority to offset for unemployment compensation debt, the State is required to promptly repay upon notice from the IRS.[1327]

Certain safeguards apply to the offset of unemployment compensation debt. Before submitting its claim to the IRS, the State must provide notice by certified mail with return receipt of its intent to the person owing the debt and provide at least 60 days for the person to submit a response, with any supporting evidence, which the State will then consider.[1328] Other conditions may be prescribed by the Secretary to ensure that the State has made reasonable efforts to obtain payment of the covered debt and that the State determination with respect to fraud is valid. If such a debt is claimed by the creditor agency to which the debt is owed, the IRS notifies the person who overpaid that the overpayment has been reduced by the amount of the debt and that such amount will be paid to the creditor agency.

The Department of Health and Human Services maintains the National Directory of New Hires ("Directory"), which is a database that contains newly-hired employee data from Form W-4, quarterly wage data from State and Federal employment security agencies, and unemployment benefit data from State unemployment insurance agencies. The Directory was created to help State child support enforcement agencies enforce obligations of parents across State lines.

Description of Proposal

The proposal would increase resources for the recovery of State unemployment benefit overpayments and delinquent employer taxes by redirecting up to five percent of overpayment recoveries to additional enforcement activity. The proposal also would require States to impose a penalty of at least 15 percent on recipients of fraudulent overpayments and restrict the use of penalty revenue exclusively to additional enforcement activity.

In addition, the proposal would expand the ability to collect benefit overpayments due to a State from a benefit recipient's Federal income tax overpayment, but does not specify how it would

[1325] Sec. 6402(f)(2).

[1326] Sec. 6402(g).

[1327] Sec. 6402(f)(7).

[1328] Sec. 6402(f)(4).

do so. The proposal also would allow States to deposit up to five percent of monies recovered in the course of an unemployment insurance tax investigation into a special fund dedicated to implementing the State Unemployment Tax Act ("SUTA") Dumping Prevention Act of 2004[1329] or enforcing State laws relating to employer fraud or tax evasion. The proposal does not change the present-law provision under which a State's ability to offset unemployment compensation debts does not apply to overpayments payable after September 30, 2018.

Finally, the proposal would require employers to report a "start work date" to the Directory for all new hires.

Effective date.–The proposal is effective on the date of enactment.

Analysis

The present-law requirement that States redeposit recoveries of unemployment benefit overpayments to the Federal Unemployment Insurance Trust Fund creates a disincentive for States to increase enforcement activity and increase overpayment recoveries (thereby keeping State unemployment taxes down and improving the solvency of the State unemployment trust funds). Permitting States to redirect five percent of overpayment recoveries to additional enforcement activity would provide States with additional resources to detect and recover overpayments. The proposal would also deter noncompliance by imposing a 15 percent penalty on fraudulent overpayments and provide States additional resources by requiring penalty proceeds to be used exclusively for enforcement activity. However, the proposal does not provide a definition of what will be considered fraudulent. The lack of a uniform definition of a fraudulent overpayment may result in disparate treatment of individuals in different States. In addition, there is a question as to whether the Federal government can ensure that amounts redirected from the Federal Unemployment Insurance Trust Fund are used exclusively for State enforcement purposes.

Present law provides States with only a limited right of offset with respect to unemployment compensation debt. The two most likely means of expanding the right of offset involve the fraud limitation or the residency requirement. First, the categories of unemployment compensation debts that may be satisfied by offset against an overpayment of Federal income tax could be expanded to include all unemployment compensation debts of the taxpayer who has made the tax overpayment and not just those obtained by fraud. Second, a State could be permitted to request an offset for the unemployment compensation debts owed by non-residents of the requesting State. [1330] The proposal may encompass either or both of these changes.

By expanding this right to all unemployment benefit overpayments, regardless of the reason for such overpayment and regardless of the State in which the benefit recipient resides, the proposal would increase the ability of States to recover overpayments. In addition, because present law

[1329] Pub. L. No. 108-295.

[1330] We note that the President's Budget includes a separate proposal that would allow the offset of Federal income tax refunds to collect delinquent State income taxes for out-of-state residents. See, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, p. 145.

already provides for an offset for fraudulently obtained unemployment insurance benefits, the proposal does not require the development of additional administrative procedures. Because the IRS would no longer need to determine whether the debts were due to fraud, some administrative savings could be realized, though the IRS will still need to determine that the debts are legally owed to the requesting State. Some may question, however, whether it is appropriate to provide States an offset right in non-fraud cases, thus, expanding the circumstances in which the Federal government acts as a collection agent for the States. Also, there is some concern that States will seek offsets for the unemployment compensation debts of non-residents before it seeks offsets for those of its current residents, resulting in the disparate treatment of similarly situated individuals.

Proponents argue that the proposal's requirement that employers report the starting date of employment for all new hires to the Directory will reduce unemployment benefit overpayments. Obtaining taxpayer data from a centralized source such as the Directory, rather than from separate State agencies, should increase the efficiency of enforcement efforts. However, others respond that allowing States to access the Directory for administering unemployment benefits extends the use of the database beyond that which was originally intended (i.e., to enable state child support enforcement agencies to be more effective in locating noncustodial parents) and raises concerns regarding the security and confidentiality of Directory information.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, 2008, 2009 and 2010 budget proposals.

E. Authorize Post-Levy Due Process

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.[1331] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[1332] and the IRS has provided both notice of intention to levy[1333] and notice of the right to an administrative hearing (referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[1334] 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.[1335]

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.[1336] 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. Upon receipt of the CDP notice, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office.[1337] Otherwise, the IRS may levy after expiration of 30 days from the CDP notice.

[1331] 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.

[1332] Sec. 6331(a).

[1333] Sec. 6331(d).

[1334] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[1335] Sec. 6321.

[1336] Secs. 6330(a)(3), 6331(d)(4). In practice, the notice of intent to levy and the collections due process notice are 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).

[1337] Sec. 6330(b).

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 when determining whether assessment of tax without following the normal deficiency procedures is permitted.[1338]

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. In each of these three cases, however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[1339]

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.[1340] 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 owed, 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.[1341] 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 of the determination of the CDP hearing in the U.S. Tax Court to ascertain whether the IRS abused its discretion in reaching its determination.[1342] During this time period, the IRS may not proceed with its levy.

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[1343] 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

[1338] Secs. 6331(d)(3), 6861.

[1339] Sec. 6330(f).

[1340] Sec. 6330(c).

[1341] Sec. 6330(c)(2).

[1342] Sec. 6330(d).

[1343] Pub. L. No. 105-34.

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.[1344]

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 these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. 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 30 days to seek judicial review of the determination of the CDP hearing by the U.S. Tax Court in order 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 FPLP. 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 is effective for levies issued after December 31, 2010.

Analysis

Proponents of the proposal believe that permitting Federal contractors who are delinquent in their employment tax liabilities to invoke CDP procedures (and thus delay collection) may succeed in depriving the Federal government of the opportunity to levy payments because, by the time the CDP requirements are completed, Treasury has likely already paid the Federal contractor. By allowing the IRS to proceed with its levy for Federal employment tax liabilities earlier in the debt collection process, proponents believe that the IRS will collect more unpaid taxes.[1345] The lost opportunity to levy payments may occur to the extent that taxpayers abuse CDP procedures and potentially raise frivolous arguments simply for the purpose of delaying or evading collection of tax.

Also, proponents argue that the opportunity to delay collection of employment tax liabilities presents a greater risk to the government than delay may present in other contexts

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[1344] 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).

[1345] Government Accountability Office, *Tax Compliance: Thousands of Federal Contractors Abuse the Federal Tax System*, GAO-07-742T (April 19, 2007) (approximately 60,000 Federal contractors were delinquent on over $7 billion in Federal taxes).

because employment tax liabilities continue to increase as ongoing wage payments are made to employees. In addition, much of an employer's employment tax liability consists of the employees' share of FICA tax withheld from employees' wages on behalf of the employees. The risk for the government is that the employees are entitled to credits for amounts actually withheld, even if the employer ultimately fails to remit these amounts to the government.

Opponents of the proposal contend that Congress enacted the CDP hearing procedures to afford taxpayers sufficient notice (together with the notice of intent to levy) of collection activity, as well as a meaningful hearing before property is seized by the IRS. By permitting the IRS to seize property prior to the CDP hearing, the proposal may increase the burden on those taxpayers with employment tax liabilities who are seeking legitimate alternatives to property seizure. Under this view, it would be appropriate to forestall seizure while legitimate efforts to resolve a tax liability are in process, provided that the interests of the IRS are adequately protected.

Others respond that the opportunity to use the present-law rules in unintended ways to delay or defeat the collection process is not unique to taxpayers with employment tax liabilities. In addition, opponents argue that it is unnecessary to provide special rules for employment tax liabilities because present law permits the IRS to levy property prior to providing the CDP hearing if collection of the tax is in jeopardy.

Prior Action

A similar proposal was included in the President's Budget for fiscal year 2010.

F. Increase Levy Authority to 100 Percent for Vendor Payments

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.[1346] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[1347] and the IRS has provided both notice of intention to levy[1348] and notice of the right to an administrative hearing (referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[1349] 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.[1350]

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 when determining whether assessment of tax without following the normal deficiency procedures is permitted.[1351]

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. In each of these three cases, however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[1352]

[1346] 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.

[1347] Sec. 6331(a).

[1348] Sec. 6331(d).

[1349] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[1350] Sec. 6321.

[1351] Secs. 6331(d)(3), 6861.

[1352] Sec. 6330(f).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[1353] 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 (including vendors) 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.[1354] The term "goods or services" is not defined in the statute. The levy (either up to 15 percent or up to 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 these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. 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 states that it is intended to clarify that the IRS can levy 100 percent of any payment due to a Federal vendor with unpaid 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 is effective for payments made after the date of enactment.

Analysis

The 100 percent continuous levy authority was enacted as part of the "American Jobs Creation Act of 2004"[1355] in order to address perceived abuses of the Federal tax system by some Federal contractors.[1356] In describing the payments to which the 100 percent continuous levy authority applied, the statute specified payments for goods or services sold or leased to the Federal Government. Because the term "goods" generally refers only to tangible personal property,[1357] the phrase "goods and services" may not encompass payments with respect to real

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[1353] Pub. L. No. 105-34.

[1354] Sec. 6331(h)(3).

[1355] Pub. L. No. 108-357.

[1356] H.R. Rep. No. 108-548, pt. 1, at 360 (2004).

[1357] American Law Institute, Uniform Commercial Code Sec. 2-105(1) defines "goods" as follows: "Goods" means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action. "Goods" also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty (Section 2-107)." This model code property, including rental payments, or royalties. As used elsewhere in the Code, the phrase "goods and services" generally refers to tangible personal property and personal services.[1358] As a result, the extent to which payments with respect to real property or intangible real property were intended to be included within the scope of the 100 percent continuous levy authority has been questioned.

Arguably, the continuous levy authority was intended to reach all Federal payments to government contractors.[1359] Thus, the use of a narrower term, which is inconsistent with its anti-abuse purpose, was inadvertent. On the other hand, FMS reported, in 2005, that it could not implement the 100 percent levy authority with respect to real property, citing the ambiguity in the language:

> The American Jobs Creation Act of 2004, authorized IRS to levy up to 100 percent of certain vendor payments. FMS modified its systems in November 2004, one month after the law was enacted, to implement this authority where 100 percent levy is available. For example, IRS recently levied 100 percent of some Defense Finance and Accounting Service (DFAS) vendor payments and collected $432,000 compared to $100,000 that would have been collected prior to the law's enactment. However, full use of this new statutory authority to levy up to 100 percent has been delayed because the provision only permits 100 percent continuous levy for payments for "goods and services" and does not appear to apply to payments made for other kinds of property. FMS stands ready to work with IRS as it attempts to reach a solution to this issue.[1360]

More recently, the FMS characterized the problem as a technical drafting error, noting that "[i]n the context of levy, we continue to seek a technical correction to the Internal Revenue Code that would allow IRS to levy up to 100% of all Federal vendor payments. This authority was generally granted in 2005 but has not been fully implemented because of a technical deficiency in the statutory language."[1361] In its description of the Budget proposal, the Office of

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has been widely adopted by State legislators, according to the UCC Locator, maintained by the Legal Information Institute at Cornell Law School, www.law.cornell.edu/uniform/ucc.html#a2.

[1358] See, e.g., Sec. 274(e)(2) ("expenses for goods, services, or facilities" used to identify certain expenses that are deductible if treated as compensation to the taxpayer's employee); Sec. 170(f)(8)(B)(ii) and (iii) (requiring that the recipient of a charitable contribution provide an acknowledgement that states whether any goods or services were provided by the charity in return for the purported donation).

[1359] The legislative history does not provide much guidance on this point except to use the statutory language. "…a Federal payment to a vendor of goods or services to the government is subject to continuous levy." H.R. Conf. Rep. No. 108-755, at 753 (2004).

[1360] Statement of Richard Gregg, Commissioner, U.S. Department of the Treasury, Financial Management Service, before the United States Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, June 16, 2005.

[1361] Statement of Kenneth R. Papaj, Commissioner, U.S. Department of the Treasury, Financial Management Service, before the United States Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, November 14, 2007.

Management and Budget similarly characterized the problem as "…an imperfection" that has the unintended effect of limiting the levy authority.[1362]

The provision eliminates any ambiguity in the statutory language such that the IRS (through the FMS) would be permitted to levy up to 100 percent of all Federal vendor payments.

Prior Action

None.

[1362] Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011: Terminations, Reductions, and Savings*, p. 111, http://www.gpoaccess.gov/usbudget/fy11/pdf/trs.pdf.

G. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents

Present law

The IRS has the authority to credit any Federal tax overpayment against any other Federal tax liability owed by the person who made the overpayment. The balance of the overpayment is generally refunded, unless a claim has been made for payment of certain non-tax debts of that person. Non-Federal tax debts that may be claimed against overpayments of Federal tax liability include past-due support (within the meaning of the Social Security Act), debts owed to Federal agencies, State income tax obligations, and unemployment compensation debts.[1363]

The order in which non-tax debts may be satisfied by offset against a Federal tax overpayment is established by statute. The highest priority is accorded to other Federal income tax debts, followed by past-due support (within the meaning of the Social Security Act)[1364] and any other debt owed to any Federal agency.[1365] If more than one unemployment compensation or State income tax debt is owed by the same resident to his State, these debts are satisfied by the overpayment in the order in which the debts accrued, without regard to whether they arise from State income tax or unemployment compensation. The actions of the IRS in reducing the overpayment to satisfy the foregoing debts are not subject to judicial review.[1366] In the event that a payment to a State is determined to have been erroneously made by the IRS in the exercise of its authority to offset for unemployment compensation debt, the State is required to promptly repay upon notice from the IRS.[1367]

Description of Proposal

Offset of Federal refunds to collect State income tax would be permissible regardless of where the delinquent taxpayer resides.

Effective date.–The proposal is effective upon date of enactment.

Analysis

In support of the proposal, the Administration points to the possibility that a delinquent taxpayer could escape Federal offset from a State as long as he or she is a nonresident. The

[1363] Sec. 6204(c) - (f).

[1364] 43 U.S.C. sec 664(c) defines "past-due support" as the amount of a delinquency, determined under a court order, or an order of an administrative process established under State law, for support and maintenance of a child (whether or not a minor), or of a child (whether or not a minor) and the parent with whom the child is living.

[1365] Sec. 6402(f)(2).

[1366] Sec. 6402(g).

[1367] Sec. 6402(f)(7).

Administration argues that foreclosing this possibility would better leverage the capacity of the Federal tax offset program for the country as a whole. By expanding the offset procedures to all State income tax debts, regardless of the State in which the taxpayer resides, the proposal increases the ability of States to collect finally determined taxes. The proposal has an added benefit, in that the development of additional administrative procedures for the State submitting the application may not be required. In addition, because the IRS would no longer need to determine whether a taxpayer remains a resident of the State requesting offset, some costs of administration could be reduced. Some may question, however, whether leveraging the capacity of the Federal offset program in this manner is appropriate, in that it effectively provides each State with a national collection agent to collect from persons who may otherwise be outside the reach of the State tax authority.

This proposal is limited to repealing the residency requirement for providing refund offsets to assist in collection of State income tax, although a State request for offset of refunds to satisfy overpaid unemployment benefits is also limited to requests with respect to debtors who reside in the requesting State. The treatment of residency in considering whether a State debt is eligible for offset against the Federal tax refund arguably should be uniform to ease administration and to avoid unfair results. In its proposal to implement unemployment insurance integrity legislation, the Administration refers to expansion of the ability to collect benefit overpayments due to a State, but does not provide further detail.[1368] It may be intended to address this same issue.

For example, present law accords State income tax obligations a relatively highly priority, after Federal income tax, child support and other Federal debts, but on the same priority as unemployment compensation. If the same taxpayer owes both State income tax and overpaid unemployment benefits, the offset is applied first to the older of the two debts. If the taxpayer is a former resident, only the income tax debt may be offset against the Federal refund, regardless of the age of the other debt. If a State is permitted to distinguish between offsets with respect to residents and non-residents is permitted, a State may seek offsets with respect to debts owed by non-residents more readily than it seeks offsets with respect to its current residents, arguably resulting in the disparate treatment of similarly situated individuals. However, enforcing a rule against consideration of residency would be difficult to enforce, and would place the IRS in the position of reviewing the administrative decisions of a State tax authority. Any draft legislation of this provision will need to address these and other issues regarding how to determine priority of competing requests for offset.

<u>Prior Action</u>

None.

[1368] See page 142, of *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, and page 503 herein for a discussion of the entire proposal regarding unemployment insurance.