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RSM McGladrey Tax Digest

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A periodic electronic newsletter highlighting developments of interest to today's companies on the move.

Provisions Affecting Business (Including Small Business)

Business (General)

Provide Additional Funds for the Advanced Energy Property Manufacturing Credit

Current Law

The American Reinvestment and Recovery Act of 2009 enacted a new 30 percent tax credit for investments in eligible depreciable, tangible property (not including a building and its structural components) used in an integral part of a qualifying advanced energy project. To qualify, the project must be to re-equip, expand or establish a manufacturing facility for the production of seven specified types of renewable energy machinery and equipment.

Total credits were limited to $2.3 billion under a program jointly administered by the Treasury Department and the Department of Energy to award certifications for qualified projects after considering applications submitted and evaluated under several criteria including commercial viability, domestic job creation, impact on reducing air pollution or greenhouse gas emissions, technological innovation, lowest energy costs and shortest completion times. After guidance on the application process was issued, taxpayers only had two months to submit their applications. Applicants must provide evidence that the requirements for certification are met within one year of the application acceptance date and must place the property in service within three years from the certification issuance date.

Proposed Law and Impact

The $2.3 billion cap on the credit resulted in less than one-third of the projects from technically acceptable applications being funded for the eligible credits. The Administration believes that the program should be expanded rather than turning down worthy applicants who are willing to invest in building and equipping factories that manufacture clean energy products in America. The proposal would authorize an additional $5 billion of tax credits for investments in eligible property used in a qualifying advanced energy project. Taxpayers will be able to apply for a credit on all or a portion of their qualifying investment in the project. The taxpayer's willingness to share in funding more of the cost of the project will be taken into account in awarding allocation of credit funds to the project. The same timing requirements in the current law with respect to meeting the certification requirements and placing the property in service would apply. Businesses that manufacture this type of renewable energy property that are considering expansion will need to move quickly on their project plans in order to take advantage of this next round of credit funding. The change would be effective on the date it is enacted.

Make the Research Tax Credit Permanent

Current Law

A taxpayer is allowed a credit against its income tax liabilities calculated as 20 percent of qualified research expenditures in excess of a "base amount." There is also a required add-back of an equivalent amount of R&D expenses to taxable income. This add-back can be avoided with an election to reduce the credit to 13 percent. Routinely, the credit expires annually and Congress has to extend it, usually for a 12- or 24-month period. Presently, the credit expired on Dec. 31 of 2009.

Proposed Law and Impact

Based on the Administration's recognition that the research tax credit encourages technological development, an important component of economic growth, the proposal would make the credit permanent, effective Jan.1, 2010 and eliminate the uncertainty about its future availability. This should allow taxpayers to factor the credit into their decisions relating to new investments in research projects. Taxpayers would not have to be concerned with a project being initiated during an eligible credit period but not completed before the expiration of the credit.

Extend and Modify the New Markets Tax Credit

Current Law

The New Markets Tax Credit (NMTC) is a credit for qualified equity investments made to acquire stock in a corporation (or capital interest in a partnership) that is a qualified community development entity (CDE) that is held for a period of seven years. The credit is based on the amount paid to the CDE for the investment at its original issue and is computed at 5 percent for the first three years and 6 percent for the subsequent four years; which totals 39 percent of the investment. The NMTC 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. The credit is recaptured if at any time during the seven-year period the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required or the equity investment is redeemed. The NMTC can be used to offset regular tax but not AMT. The NMTC expired on Dec. 31, 2009.

Proposed Law and Impact

Once again, effective on the date of enactment, -the proposal would extend- the NMTC for two years, through Dec. 31, 2011 with an allocation of $5 billion per year and would make other improvements to the NMTC. This would allow CDEs to continue to generate investments in low-income communities. Taxpayers looking to expand their businesses may want to consider investing in CDEs to take advantage of this credit.

Reinstate Superfund Excise Taxes

Current Law

Before Jan. 1, 1996 there were three Superfund excise taxes: (1) an excise tax on domestic crude oil and on imported petroleum products at a rate of $0.097 per barrel, (2) an excise tax on listed hazardous chemicals at a rate that varied from $0.22 to $4.87 per ton; and (3) an excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2). The revenues from these taxes were dedicated to the Hazardous Substance Superfund Trust Fund. These amounts are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment.

Proposed Law and Impact

Due to the continuing need for funds to remedy damages caused by releases of hazardous substances, the three Superfund excise taxes would be reinstated for taxable years beginning after Dec.31, 2010 and would sunset for taxable years beginning after Dec. 31, 2020.

Reinstate the Superfund Environmental Income Tax

Current Law

A corporate environmental income tax was imposed at a rate of 0.12 percent on the amount by which a corporation's modified alternative minimum taxable income exceeded $2 million for taxable years beginning before Jan. 1, 1996. A corporation's modified alternative minimum taxable income was its alternative minimum taxable income determined without regard to the alternative minimum tax net operating loss deduction and the deduction for the corporate environmental income tax.
The tax was dedicated to the Hazardous Substance Superfund Trust Fund (Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment.

Proposed Law and Impact

Due to the continuing need for funds to remedy damages caused by releases of hazardous substances, the corporate environmental income tax would be reinstated for taxable years beginning after Dec.31, 2010 and would sunset for taxable years beginning after Dec.31, 2020.

Proposed Change in Treatment of Carried Interests

The Obama administration proposes taxing carried (profits) interests as ordinary income and self-employment income. This proposal is designed to eliminate a technique used by hedge funds and other investment entities (including real estate partnerships) to compensate their organizers in a manner that leads to such compensation being treated as capital gains and certain dividends.

Current Law

Allocations of partnership income and losses attributable to a partner's carried/profits interest in a partnership (an interest received in exchange for services), are treated the same as allocations attributed to a partnership interest received in exchange for property or other invested capital. As such, these allocations retain the tax character of the partnership income and gain, which can include such tax benefits as treatment as long-term capital gain and certain dividends, presently taxed at 15 percent for high income taxpayers. To the extent that such carried interest income is treated as long-term capital gains and certain dividends, it also avoids treatment as self-employment income, which otherwise would be the case.

Proposed Law and Impact

The Obama administration sees an unfair situation where compensation for services attributable to carried interests income is taxed at a lower rate than other forms of service income. The Obama administration proposes to level the playing field by designating the interest in any partnership that is earned as a result of a partner's services to the partnership as a services partnership interest (SPI). The taxation of an SPI would be:

1) The portion of that partner's SPI income that is not attributable to invested capital would be ordinary income regardless of the character of that income at the partnership level,
2) The partner would be required to pay self-employment taxes on such income and,
3) The gain recognized on the sale of an SPI that was not attributable to invested capital would generally be taxed as ordinary income, not as capital gain.

A partnership allocation attributable to a service partner's invested capital, however, would retain the tax characteristics of partnership items allocated to the partner. In addition, the Administration proposes to treat income or gain arising from certain "disqualified interests" that are related to the partnership (such as convertible or contingent debt, an option or any derivative) as ordinary income.

A number of legislative proposals that would adopt this approach have already been made and another has been suggested to pay for an "extenders" bill, but at least one lobbyist has been quoted as saying that some members of the Senate Finance Committee are reluctant to act while the economy has not yet recovered. This proposal would be effective for taxable years beginning after Dec. 31, 2010.

Increase Certainty with Respect to Worker Classification

Current Law

Worker classification is generally based on a common-law test, where workers must be classified, for both tax and nontax purposes, as either employees or self-employed (often referred to as independent contractors). The main determinant is whether the service recipient has the right to control the result of the worker's services, and the means by which the worker accomplishes that result. It does not matter whether the service recipient exercises that control, only that he or she has the right to exercise it. In determining worker status, the IRS looks to three categories of evidence under the common-law test: behavioral control, financial control, and the relationship of the parties.

For employees, employers are required to withhold income and FICA taxes, pay the employer's share of FICA, and pay Federal Unemployment Tax Act (FUTA) taxes.

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For workers classified as independent contractors, service recipients that make payments totaling $600 or more in a calendar year to an independent contractor (other than an independent contractor that is a corporation) are required to send an information return to the IRS and the contractor stating the total payments made during the year.

Under a special provision (section 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor even though the worker may be an employee under common law rules. The special provision applies if the service recipient has a reasonable basis for treating the worker as an independent contractor and only if: (1) the service recipient has not treated the worker (or any worker in a substantially similar position) as an employee for any period beginning after 1977 and; (2) the service recipient has filed all Federal tax returns, including all required information returns, treating the worker as an independent contractor. If an employer meets the requirements for the special provisions with respect to a class of workers, the IRS is prohibited from reclassifying the workers as employees, including newly hired workers in the same class.

Proposed Law and Impacts

The Obama administration believes some workers are incorrectly classified as independent contractors. The Obama administration also believes certain benefits and worker protections are denied some workers classified as independent contractors. In addition, according to the Obama administration, incorrect worker classification may create competitive advantages for some service recipients. As a result, the Obama administration believes workers, service recipients and tax administrators would benefit from reducing uncertainty about worker classification.

Under the proposal, the IRS would be permitted to require prospective reclassification of workers they determine are currently misclassified and whose reclassification has been prohibited under current law. The Department of Treasury and IRS would also be permitted to issue generally applicable guidance on proper worker classification under common law standards and would be directed to issue guidance on a neutral basis in a manner that recognizes many workers are not employees. The guidance would provide safe harbors and/or rebuttable assumptions, both narrowly defined, and the guidance would generally be industry or job specific.

Service recipients would be required to give notice to an independent contractor when he or she first begin providing services to the service recipient, explaining how the worker would be classified, and the tax, worker's compensation and wage and hour implications.

Independent contractors receiving payments totaling $600 or more in a calendar year would be permitted to require the service recipient to withhold for Federal tax purposes a flat rate percentage of their gross payments. The withholding percentage would be selected by the contractor.

The proposal would be effective upon enactment, but prospective reclassification of workers would not be effective until the first calendar year beginning at least one year after date of enactment.

Financial Crisis Responsibility Fee

Current Law

Current law does not impose a federal tax specific to financial firms. These firms are subject to the general corporate income tax, certain excise taxes, and to a range of fees such as those assessed on banks by the Federal Deposit Insurance Corporation.

Proposed Law and Impact

The Administration feels excessive risk was undertaken by major financial firms and believes this was a significant cause of the recent financial crisis. The proposed fee, required to be proposed under the Troubled Asset Relief Program (TARP), is intended to pay back the federal government the costs of actions taken to combat the crisis, such as funds injected into the financial system, guarantees of certain types of securities, and the purchase of securities from certain firms. The fee is also intended as a deterrent against excessive leverage for large financial firms.

The Financial Crisis Responsibility Fee would be applied to large banks, thrifts, bank and thrift holding companies, brokers and securities dealers with consolidated assets of $50 billion or more. The assessable base of the fee would include the worldwide consolidated liabilities of U.S financial firms, and the liabilities of the U.S. subsidiaries of firms not based in the U.S.

The fee would be applied at a rate of approximately 15 basis points (15/100 of 1 percent) to the firms' covered liabilities. Covered liabilities would be determined using balance sheet information filed with Federal or state regulators. The fee would be effective as of July 1, 2010, and firms subject to the fee would report the fee on their annual federal income tax returns and pay it along with their regular estimated income tax payments.

Deny Deduction for Punitive Damages

Current Law

As a general rule, taxpayers may deduct punitive damages that originated as a result of the taxpayer's business activities, subject to IRC section 162(f) (disallows deductions for fines or similar penalties paid to a government for the violation of any law) or IRC section 162(g) (if taxpayer convicted in criminal action or violation of antitrust laws, or enters a plea of guilty or nolo contendere to such violation, no deduction is allowed for 2/3 of any amount paid or incurred on a judgment for damages or in settlement of any action brought under section 4 of the Clayton Antitrust Act on account of such antitrust violation).

Proposed Law and Impact

Under the Obama administration's proposal, no deduction would be allowed for punitive damages paid or incurred by a taxpayer, whether upon a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, the damages paid or incurred by the insurer would be included in the gross income of the insured. The insurer would be required to report such payments to the insured and to the IRS. The proposal would apply to damages paid or incurred after Dec. 31, 2011.

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Require a Certified Taxpayer Identification Number from Contractors and Allow Certain Withholding

Current Law

Service recipients making payments aggregating $600 or more in a calendar year to any non-employee service provider ("contractor"), other than corporate contractors, are required to send an information return to the IRS, reporting the amount paid as well as the contractor's name, address, and taxpayer identification number (TIN). The information returns are required annually after the end of the year and are made on Form 1099-MISC. Copies of the information returns are provided to both the contractor and the IRS. Tax withholding is not required or permitted for payments to contractors. Since contractors are not subject to withholding, they make quarterly payments of estimated income taxes and self-employment taxes, and pay any balance due when the annual income tax return is filed.

Proposed Law and Impact

Estimated tax filing is potentially burdensome for some taxpayers, and by the time estimated or final tax payments are due, some contractors have not put aside the necessary funds. With the self-employment tax rate at 15.3 percent, a contractor's required estimated tax payments can be more than 25 percent of the contractor's gross receipts. An optional withholding method for contractors would reduce quarterly estimated tax payment burdens, automatically set aside funds for the contractor's tax payments, and would increase compliance.

Under the Administration's proposal, a contractor receiving payments of $600 or more in a calendar year from a service recipient would be required to furnish the payer the contractor's certified taxpayer identification number (TIN on Form W-9). The service recipient would be required to verify the contractor's TIN with the IRS.

If the contractor fails to furnish an accurate certified TIN, the service recipient would be required to withhold a flat-rate percentage of the gross payments. Contractors, in turn, could require the service recipient to withhold a flat-rate percentage of their gross payments. The percentage, selected by the contractor, could be at a 15, 25, 30 or 35 percent rate.

The proposal would be effective for payments made to contractors after Dec.31, 2010.

Require Information Reporting on Payments to Corporations

Current Law

A taxpayer making payments to a recipient aggregating $600 or more in a calendar year for services or determinable gains is required to send an information return to the IRS, reporting the amount paid as well as the recipient's name, address, and taxpayer identification number (TIN). The information returns are required annually after the end of the year and are made generally on Form 1099. Certain exceptions apply for payments to corporations, as well as tax-exempt and government entities.

Proposed Law and Impact

A business would be required to file an information return for payments to a corporation (except for tax exempt corporations) for services or for determinable gains aggregating $600 or more in a calendar year. Regulatory authority would be provided to make appropriate exceptions where reporting would be especially burdensome.

The proposal would be effective for payments to corporations after Dec.31, 2010.

Codification of Economic Substance Doctrine

Current Law

Economic substance is a judicially created doctrine generally requiring that a transaction have real and meaningful economic significance beyond expected tax benefits. Currently there is not a consistent application by the Circuit Courts.

Proposed Law and Impact

As expected, the budget proposal includes the codification of the "economic substance doctrine." The proposal would adopt a two-pronged test. Taxpayers would need to satisfy both prongs to demonstrate that a transaction has economic substance. First, the transaction would need a non-tax business purpose and second, the transaction would need to result in a meaningful change to the taxpayer's economic position. Further, when considering the impact of future profit potential in establishing that economic substance existed for a particular transaction, the present value of the reasonably expected pre-tax profit would be weighed against the present value of the expected tax benefits. New penalties would apply to an understatement of tax resulting from a transaction that lacked economic substance and deny interest deductions for interest charged on the underpayment.

Effective for transactions entered after enactment, the proposal would not limit application of the two-pronged test to tax shelter transactions; rather it would grant regulatory authority to the Treasury to provide rules for its application. As a result, it is unclear what impact this proposal would have on traditional tax planning.

Income accrual on forward sales of corporate stock

Current Law

In general, a corporation recognizes no gain or loss when it issues its stock in exchange for property. As a result, a corporation's stock can represent valuable currency to the issuing corporation. In forward stock sale transactions, the issuing corporation agrees to issue its stock in exchange for future payment to the issuer. Under current law, this arrangement results in no income to the issuer upon the receipt of the future payments.

Proposed Law and Impact

To conform a forward sale to a current sale of stock in a deferred payment arrangement, the proposal would require that the issuing corporation accrue income (similar to accrued interest). As a result, the payment received by the issuing corporation would include a component of taxable income for the time value of money and would be applicable to forward contracts entered after Dec.31, 2011.

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Repeal of the Gain within Boot Benefits of the "All Cash D" Repatriation Strategy

Current Law
As currently written, the Internal Revenue Code limits the amount of potential dividend in a tax deferred reorganization to the gain realized in the reorganization. The provision often assists limiting gain in so called "all cash D reorganizations." As a result, using an "all cash D reorganization," a domestic taxpayer owning a foreign subsidiary with a tax cost basis that approximates value has the ability to repatriate cash from its other foreign subsidiaries with minimal dividend income.

Proposed Law and Impact
To close this perceived loophole, the proposal would remove the statutory limitation on dividend characterization of boot issued in an otherwise qualifying section 368 reorganization. The proposal would apply to transactions effective after 2010.

Expanded Definition of Control for Determining Disallowance of Bond Repurchase Premium

Current Law
Currently, section 249 of the Internal Revenue Code disallows the deduction for bond repurchase premium if the repurchased debt is convertible into stock of the issuing corporation or certain "controlled" subsidiaries of or a corporation controlling the issuer. The applicability is limited to the parent and first-tier subsidiaries in which the parent owns 80 percent of the voting power and 80 percent of each class of stock not eligible to vote.

Proposed Law and Impact
Believing that the current definition of control unnecessarily limits the application of the current law, the proposal would adopt a more liberal definition of control. The new definition would include any chain of corporations that includes a common parent corporation and any subsidiary that has at least 80 percent of its vote and value owned within the controlled group. The proposal would be effective on the date of enactment.

Extend Temporary Bonus Depreciation for Certain Property

Current Law
IRC section 168(k) allows an additional first-year depreciation deduction for qualified property placed in service during 2008 and 2009 (or 2010 for certain long-lived property).Qualified property includes original use MACRS property with a recovery period of 20 years or less, certain computer software, water utility property, and qualified leasehold improvements. Bonus depreciation automatically applies for regular tax and AMT purposes unless a taxpayer elects out of the provisions for an entire class of property. In addition, in lieu of claiming bonus depreciation, corporations may elect to claim additional R&D or AMT credits for eligible qualified property.

Proposed Law and Impact
The Obama administration proposes to extend bonus depreciation for one year, for property acquired and placed in service during 2010 (or 2011 for certain long-lived property).The proposal also includes a one-year extension of the election to claim additional R&D or AMT credits in lieu of bonus depreciation, again with a significant impact on small business.

Repeal LIFO Method of Accounting for Inventories

Current Law
Last-in, first-out (LIFO) accounting is a historical method of recording the value of inventory which benefits taxpayers in times of inflation. A company records the last units purchased as the first units sold. Since most inventory prices have generally risen over time, LIFO records the sale of the most expensive inventory first—increasing cost of goods sold as compared to reporting the inventory under a first-in, first-out (FIFO) method of accounting. This results in a company having decreased profits and reduced taxes.

Proposed Law and Impact
The current proposal is to repeal LIFO effective for the first tax year beginning after Dec. 31, 2011. If repealed, a taxpayer would be required to write up the value of its LIFO inventory to a FIFO value, with the increase in gross income taken into account ratably over 10 years. A repeal of LIFO would (i) eliminate a tax deferral opportunity for taxpayers that may have inventories whose costs increase over time, (ii) simplify the Internal Revenue Code by eliminating a complex inventory method, and (iii) remove one of the impediments to the implementation of International Financial Reporting Standards (IFRS) in the United States.

Repeal LCM Inventory Accounting Method

Current Law
Certain taxpayers are permitted to use a lower-of-cost-or-market (LCM) method for valuing FIFO inventory. A taxpayer may write down the carrying value of FIFO inventories to replacement or reproduction cost resulting in larger deductions when the replacement or reproduction cost falls. A FIFO taxpayer may also write down the cost of subnormal goods to reflect their decline in value—also resulting in a larger tax deduction.

Proposed Law and Impact
The current proposal would prohibit taxpayers from writing down the value of FIFO inventories. These changes would be effective for taxable years beginning after 12 months from the date of enactment, and any one-time increase in gross income would be included ratably over a four-year period beginning with the year of change.

Business (Small)

Extend Temporary Increase in Expensing for Small Business

Current Law
The IRC section 179 expensing limit of $250,000 and investment limit of $800,000 were extended through 2009. For 2010, the maximum deduction amount is $125,000 and the maximum investment amount is $500,000 (indexed for inflation).

Proposed Law and Impact
The Obama administration proposes to continue the increased $250,000 expensing limit and $800,000 annual investment limit for one year, through 2010.These could significantly encourage small business investment.

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Continue 15-year Recovery Period for Qualified Leasehold Improvements and Qualified Restaurant Property

Current Law

Qualified leasehold improvement property (as defined in IRC sections 168(k)(3) and 168(e)(6)) must be placed in service before Jan. 1, 2010, to qualify for bonus depreciation and the 15-year recovery period. Any qualified restaurant property (as defined in IRC section 168(e)(7)) must be placed in service before Jan. 1, 2010, to qualify for the 15-year recovery period. Qualified restaurant property is not eligible for bonus depreciation.

Proposed Law and Impact

The Obama administration proposes to continue through Dec. 31, 2011 the 15-year recovery period for qualified leasehold improvements and qualified restaurant property.

Eliminate Capital Gains on Small Business Stock Sales

Current Law

Originally, taxpayers other than corporations were permitted to exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The exclusion was increased to 60 percent for businesses operating in specified empowerment zones. The American Recovery and Reinvestment Act raised the exclusion to 75 percent for stock acquired after Feb. 17, 2009 and before Jan. 1, 2011. The taxable portion of the gain is taxed at a maximum rate of 28 percent. Present law treats 7 percent of the excluded gain as a tax preference subject to Alternative Minimum Tax. The amount treated as a tax preference is scheduled to increase after Dec. 31, 2010 to 28 percent for stock acquired after Dec.31, 2000 and 42 percent for stock acquired prior to 2001.

To qualify as a "small business" for purposes of the exclusion, the corporation may not have gross assets exceeding $50 million including the newly invested capital at the time of issue. The amount of gain eligible for exclusion is limited to the greater of ten times the basis of the stock sold, or $10 million reduced by gain excluded by the taxpayer on the same corporation's stock in prior year; stock in S corporations is not eligible for exclusion. Also, the corporation must be engaged in an active business and certain personal service businesses are not eligible.

Proposed Law and Impact

The exclusion for gain on the sale of small business stock would be increased permanently to 100 percent and the Alternative Minimum Tax preference treatment would be eliminated for stock acquired after Feb. 17, 2009. As with prior law, the stock would have to be held for at least five years to qualify. Other requirements of prior law would continue to apply.

The effective tax rate on qualified investments would be zero. This could prove to be particularly attractive as an incentive and reward to high-income taxpayers who invest in small businesses. The exclusion would be even more attractive if the tax rate on capital gains from regular investments is raised beyond the current 20 percent level.

Electronic Filing Requirements Expanded to Include More Taxpayers

Current Law

Corporations with assets of $10 million or more which file form 1120 and which file at least 250 returns (W-2s, 1099s, etc.) annually with the IRS are required to electronically file their income tax returns, unless they are granted a waiver due to technological hardship.

Proposed Law and Impact

All taxpayers which are required to file a Schedule M-3 (partnerships and corporations) would also be required to file electronically. Essentially, while adding partnerships to the list of taxpayers required to e-file, the proposal would also impact other taxpayers by authorizing the IRS to reduce the 250 return requirement that exempted smaller corporate taxpayers from the e-filing requirement. Taxpayers who could prove that technological limitations prevent them from e-filing would still be able to ask for a waiver from the requirement.

The proposal would be effective for tax years ending after Dec. 31, 2010.

Provisions Affecting U.S. Taxation of Foreign Income

The proposals would significantly change the way foreign income is taxed for United States taxpayers operating offshore. Deferral techniques as well as foreign tax credit planning would be substantially altered.

Extension of Expiring "Look-Through" and "Active Financing" Provisions for Controlled Foreign Corporations

Current Law

The current law allows a special limited-time "look-through" provision for certain types of payments (i.e., dividends, interest, royalties) received by a controlled foreign corporation (CFC) from a lower-tiered CFC. This provision allowed the recipient CFC to consider the underlying activities of the payer in order to avoid triggering an immediate U.S. income inclusion. Utilization of this provision is common to the establishment of foreign holding company structures. Holding structures allow deferral of U.S. tax on foreign earnings. The extension was to expire for tax years beginning on or after Jan. 1, 2010. Current law also allows CFCs to consider qualifying "active financing" income as business income exempt from classification as subpart F income currently taxable to U.S. shareholder.

Proposed Law and Impact

These provisions will be extending the benefit through Dec. 31, 2011 to avoid uncertainty for taxpayers.

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Foreign Tax Credit Reform: Determine the Foreign Tax Credit on a Pooling Basis

Current Law

Current law allows a U.S. parent company a foreign tax credit for taxes paid by its foreign subsidiary. Section 902 allows a credit for underlying taxes paid by subsidiaries known as the "deemed paid credit." The amount of foreign tax available is directly attributed to a distribution of income or other inclusion of income from the foreign subsidiary. The foreign tax credit limitation conceptually limits the U.S. tax credit to the lesser of the actual foreign tax or the pre-credit U.S. tax on the foreign income. To maximize foreign tax credit utilization, companies commonly seek opportunities to blend the effective foreign tax rate from multiple foreign sources, seeking to mix high-tax and low-tax foreign income.

Proposed Law and Impact

This provision will force taxpayers to consolidate the earnings and taxes of all of their foreign subsidiaries into an annual pool. No regard is given to the particular foreign subsidiary creating the U.S. taxable income. The proposal will force a blended foreign tax rate, potentially with little relationship to the trade or business generating U.S. taxable income. The blending of rates will likely reduce the available foreign tax credit and likely drive up the worldwide effective tax rate of the enterprise. The proposed modification supports a belief that multinational businesses utilize low tax countries to shelter earnings rather than for legitimate business reasons. The proposal would be effective for taxable years beginning after Dec. 31, 2010.

Repeal 80/20 Company Rules

Current Law

If at least 80 percent of a domestic company's gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business, it is subject to look-through rules to determine the character of certain income. This rule can be applied to avoid U.S. withholding when recipient is a foreign person.

Proposed Law and impact

The administration believes these rules can be manipulated and will be repealed for years beginning after Dec. 31, 2010.

Defer Deduction of Interest Expense Related to Deferred Income

Current Law

U.S. Tax law provides a deduction from income for ordinary and necessary expenses pursuant to carrying on a trade or business. Subject to allocation and apportionment rules, taxpayers can deduct interest expense associated with income from foreign investments, the taxation of which is deferred for U.S. tax purposes. A commonly cited example is acquisition indebtedness incurred by a U.S. affiliate to make a foreign investment or acquisition.

Proposed Law and Impact

The proposal will defer the deduction of interest expense associated with a taxpayer's foreign source income that is not currently subject to tax. The proposal uses current allocation and apportionment rules to determine the deferred amount. The amounts carry over for utilization at time the income is repatriated.

Traditional financing of outbound enterprises utilizes equity and assets of the Parent Company in the U.S. to back foreign investment. Investment analysis that includes associated tax benefits is common to expanding companies and can have a significant impact on an investment decision. Imposition of deferred acquisition deductions will raise the internal cost of capital and affect cash flow of any deal. The proposal would be effective for taxable years beginning after Dec. 31, 2010.

Limit Earnings Stripping by Expatriated Entities

Current Law

The current Internal Revenue Code potentially limits the deductibility of interest paid to related persons to the extent that the company fails the debt to equity safe harbor (currently 1.5 to 1) and has interest expense that exceeds 50 percent of its adjusted taxable income (essentially a cash basis taxable income). Certain U.S. entities enter into transactions that result in an "expatriation" whereby a U.S. parent company would essentially be replaced by a foreign parent company while the legacy shareholders remain largely intact.

Proposed Law and Impact

The Treasury Department found strong evidence that entities involved in expatriation transactions were commonly loaded up with a significant amount of debt to reduce future U.S. taxable income. To curb this perceived abuse, for expatriated entities, the proposal would eliminate the safe harbor debt rule and reduce the limitation threshold to 25 percent of adjusted taxable income on interest paid to related parties, excluding interest paid to an unrelated party in which the debt is subject to a related party guarantee.

This provision is narrowly targeted at entities that entered into expatriation transactions for years beginning after July 10, 1989. These provisions would be effective for taxable years beginning after Dec. 31, 2010.

Limit Shifting of Income through Intangible Property Transfers

Current Law

The current transfer pricing laws require that upon the transfer (or license) of intangible property, the income with respect to the transfer must be "commensurate" with the income attributable to the intangible property. In addition, on a transfer of intangible property to a foreign corporation, there are provisions that also attempt to subject the transfer to U.S. tax in an amount that is "commensurate" with the transferee's income from the property. The government is concerned with the ability of taxpayers to circumvent the application of U.S. tax on intangible transfers outside of the U.S. and thereby avoid tax.

Proposed Law and Impact

Valuation and pricing of these transactions has been an area of widespread disputes between the IRS and taxpayers. To prevent the shifting of income outside the U.S., the proposal would clarify

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the definition of intangible to include workforce in place, goodwill, and going concern value. The proposal also grants the Commissioner greater flexibility in the methodology for valuing such transfers. The additional latitude and powers granted to the Commissioner will increase the burden borne by taxpayers entering into similar transactions. These provisions would be effective for taxable years beginning after Dec. 31, 2010.

Tax Currently Excess Returns Associated With Transfers of Intangibles Offshore

Current Law

Internal Revenue Code Section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership. The Code and regulations require changes whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organization." Section 482 regulations further provide that the prevailing standard is that of unrelated persons dealing at arm's length. The government believes potential savings of related party transfers to low-tax affiliates puts too much pressure on the enforcement and effective application of the transfer price rules.

Proposed Law and Impact

The proposal provides the Service an additional tool in its transfer price arsenal. Where a U.S. taxpayer transfers intangible property to a jurisdiction where a low foreign effective tax rate exists and the Service determines that "circumstances and evidence exist of excessive income shifting", the deemed excessive income will be immediately taxed to the parent under Subpart F. Furthermore, the Subpart F income will have a separate foreign tax credit limitation basket. The impact to legitimate business decisions is potentially enormous. Taxpayers who successfully develop and fully utilize the capabilities of human capital or production capabilities throughout the world to optimize shareholder value would now be subject to a facts and circumstances test, measured by the government to determine if their business decisions were prudent management or deemed an "excessive income shift." The proposal would be effective for tax years beginning after Dec.31, 2010.

Increased Disclosures and Associated Penalties for Non Compliance

Current Law

Currently there are several disclosure requirements for corporations or individuals with financial or related-type accounts in a cross border situation. Self-reporting of accounts and transactions is a stalwart in our tax system. The statutes and regulations currently provide penalties for deliberately avoiding the disclosure requirements. Recently, Treasury and the Service have fortified their stance on compliance and have begun an initiative to assess and enforce disclosure penalties after many years of tacit approval.

Proposed Law and Impact

To reduce perceived evasion of taxes by hiding financial accounts, trusts, or corporations offshore, the proposal significantly strengthens information reporting and withholding systems that support U.S. taxation of income earned or held through offshore accounts or entities.

- A withholding agent will withhold tax at a rate of 30 percent on payments of U.S. sourced fixed or determinable annual or periodic income (FDAP) to a foreign financial institution (FFI). In addition withholding will apply to proceeds from the sale of any property of a type that produces U.S. source FDAP income. The withholding requirement remains in place unless the FFI has entered into an agreement with the IRS to fulfill various reporting requirements.

- A withholding agent making a payment of U.S.-source FDAP income and gross proceeds from the sale of any property of a type that can produce U.S.-source interest or dividends to a foreign entity (other than FFI) will be required to withhold 30 percent unless the foreign entity certifies that no U.S. person owns, directly or indirectly, an interest of more than 10 percent in the entity.

- Any U.S. individual who holds an interest in a foreign financial account, an interest in a foreign entity or any financial instrument or contract held for investment and issued by a foreign person will be required to file an information return if the aggregate value of all such assets exceeds $50,000. Penalties for lack of disclosure will be $10,000. However, the disclosure with the tax return does not eliminate Financial Bank Account Reporting (FBAR) reporting with the Treasury.

- The proposal would extend the statute of limitations for significant omission of income attributable to foreign assets. If the taxpayer omits from gross income more than $5,000 that is attributable to one or more financial assets, the statute of limitations will be extended to six years after the required return is filed.

- A U.S. individual will 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 the financial account by the individual. Similar rules apply for any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest. Failure to disclose a covered transaction creates a penalty equal to the lesser of $10,000 or 10 percent of the transaction values.

These proposals generally go into place in the year of enactment or for years beginning after Dec. 31, 2012.

Strengthening Foreign Trust Disclosure and Reporting Requirements and Penalties

Current Law

A U.S. individual who directly or indirectly transfers property to a foreign trust is the owner of the portion of the trust attributable to the property for any year in which there is a U.S. beneficiary. An exception permits a situation where, under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the year to or for the benefit of a U.S. person. Current disclosure requirements are difficult for the Service to

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enforce and make it difficult for the Service to determine whether the trust has a U.S. beneficiary.

Furthermore, certain information must be reported to the IRS with respect to certain foreign trusts. A civil penalty applies to personas who fail to timely file a return or who file incomplete returns. The penalty is equal to 35 percent of the gross reportable amount.

Proposed Law and Impact
In both situations, it is difficult for the Service to track reporting compliance and information about the trusts. Without active reporting by individuals, the Service relies on third party information or other public records to discover the trust. The proposal strengthens reporting requirements by making any transfer to a foreign trust by a U.S. individual considered a foreign trust unless the individual making the transfer timely files all required disclosures to prove the trust does not have U.S. beneficiaries. Furthermore, the proposal accelerates the $10,000 or 35 percent penalty. The continued failure to disclose generates an additional $10,000 penalty per occurrence.

Double Penalties on Unreported Income from Non-Disclosed Foreign Bank Accounts

Current Law
An accuracy related penalty of 20 percent can be applied in situations in which there is a substantial understatement of income tax or an understatement from negligence or disregard of the tax rules. An understatement relating to a reportable transaction can be subject to a 20 percent penalty that increases to 30 percent if the reportable transaction is not adequately disclosed.

U.S. taxpayers are required to disclose the existence of a financial interest in a financial account located in a foreign country and provide details by filing a "Report of Foreign Bank and Financial Accounts (FBAR)."

Proposed Law and Impact
The Obama Administration has shown a great deal of concern relating to the potential tax evasion associated with taxpayers setting up offshore accounts. Under the proposal, the accuracy related penalty would be doubled to 40 percent for understatements that arise from a transaction involving a foreign account that the taxpayer failed to disclose within its filings as required under another Obama Administration proposal. In addition, the understatement penalty for a reportable transaction would remove the "reasonable cause" exception. Finally, another proposal would increase the foreign account information to be disclosed on the taxpayer's income tax return.
Unlike many of the international related provisions, these proposed provisions would apply for taxable years beginning after Dec. 31 of the year of enactment.

Provisions Affecting High Net Worth Individuals

Increase Individual Income Tax Rates to 39.6 Percent and 36 Percent

Current law
The highest and second highest individual income tax rates are 35 percent and 33 percent, respectively.

Proposed Law and Impact
Beginning on Jan.1, 2011, the highest and second highest individual income tax rates would be 39.6 percent and 36 percent, respectively. These rates would apply to taxpayers with taxable income starting at $250,000 for joint filers and $200,000 for single filers (both indexed for inflation from 2009). Increasing the individual income tax rates of high income taxpayers would reduce the deficit, make the system more progressive and redistribute the cost of government.

Increase the Tax Rate on Net Long-Term Capital Gains and Qualified Dividends to 20 Percent

Current Law
The maximum tax rate on net long-term capital gains and qualified dividends for individuals is 15 percent. Any net long-term capital gains and qualified dividends that would have been otherwise taxed at the 10 percent or 15 percent income tax rates are taxed at zero percent. These rates apply to both regular tax and AMT.

Proposed Law and Impact
For years beginning on or after Jan.1, 2011, the tax rate on net long-term capital gains and qualified dividends would increase to 20 percent. This increase would apply to joint filers with income exceeding $250,000 and to single filers with income exceeding $200,000 (both indexed for inflation from 2009 and reduced by the amount of the standard deduction and two or one personal exemption amounts depending of filing status). The 2009 standard deduction for joint filers is $11,400 and the 2009 exemption amount is $3,650. If the proposal were effective for 2009, the threshold would be $231,300. The Obama administration supports keeping the tax rate on net long-term capital gains and qualified dividends low. Increasing the tax rate to 20 percent for high income taxpayers would keep the top tax rate for net long-term capital gains and qualified dividends at historically low levels.

The Obama administration wants to protect the lower and middle income taxpayers from this rate increase. Therefore, the zero and 15 percent tax rates for net long-term capital gains and qualified dividends would be extended permanently for taxpayers with income up to $250,000 for joint filers and $200,000 for single filers (both indexed for inflation from 2009).

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Increase the Limitation on Itemized Deductions

Current Law
Allowable itemized deductions (other than medical expenses, investment interest expense, theft and casualty losses, and gambling losses) are reduced when adjusted gross income (AGI) exceeds $166,800. The reduction is a calculation based on AGI.

Proposed Law and Impact
Beginning on Jan.1, 2011, allowable itemized deductions (other than medical expenses, investment interest expense, theft and casualty losses, and gambling losses) would be reduced when AGI exceeds $250,000 for joint filers and $200,000 for single filers (both indexed for inflation from 2009). The reduction would be the lesser of 3 percent of the amount AGI exceeds $250,000 for joint filers ($200,000 for single filers) or 80 percent of otherwise allowable itemized deductions.

Additionally, when the taxpayer has income subject to a tax rate higher than 28 percent, the reduction in tax liability due to itemized deductions would be limited to 28 percent of the value of those itemized deductions.

By imposing these limitations on high income taxpayers, the system would be more progressive, the deficit would be reduced, and the cost of government would be redistributed among taxpayers.

Reinstate the Personal Exemption Phase-Out

Current Law
Taxpayers are entitled to a personal exemption for the taxpayer and each dependent; the amount of the exemption is indexed annually for inflation. The personal exemption begins to phase-out when AGI exceeds $250,200 for joint filers and $166,800 for single filers. However, each taxpayer receives a minimum benefit for each personal exemption regardless of income level.

Proposed Law and Impact
Again, the Obama administration seeks to reduce the deficit, make the system more progressive, and redistribute the cost of government among taxpayers. Beginning Jan.1, 2011, the personal exemption would begin to phase-out when AGI exceeds $250,000 for joint filers and $200,000 for single filers (both indexed for inflation from 2009).

The personal exemption would be reduced by 2 percent of the exemption amount for each $2,500 or fraction thereof by which AGI exceeds $250,000 for joint filers and $200,000 for single filers (both indexed for inflation from 2009). Therefore, high income taxpayers would not receive any benefit for personal exemptions.

Require Minimum Term for GRAT Grantor Retained Annuity Trusts (GRATS)

Current Law
A GRAT is an irrevocable trust created for a specific term of years which is intended to terminate prior to the grantor's death. During the term, the grantor receives an annuity from the trust. A GRAT is funded with assets intended to appreciate in value with the goal that at the end of the term there will be assets left in the trust which will be distributable to the grantor's children.

Proposed Law and Impact
Frequently, a grantor retained annuity trust (GRAT) is structured to exist for a short period of time. They are created to transfer assets to the grantor's beneficiaries at a greatly reduced or eliminated gift tax cost.

Under the Obama administration's budget proposal, GRATs would have a minimum term of 10 years, thus increasing the odds that the grantor will die before the GRAT terminates and thereby reducing the likelihood that there will be a gift tax free transfer. In addition, the proposal includes a requirement that the remainder interest has a value greater than zero and would prohibit any decrease in the annuity during the GRAT term.

The proposal would apply to trusts created after the date of enactment.

Modify Rules on Valuation Discounts

Current Law (assumed by the Obama administration the same as 2009 law)
The fair market value of property, whether on the death or during the lifetime of the transferor, generally is subject to estate or gift tax at the time of the transfer. Sections 2701- 2704 of the Internal Revenue Code were enacted to prevent the reduction of taxes through various techniques, including estate freezes, designed to reduce the value of the transferor's estate and discount the value of the taxable transfer to the beneficiaries of the transferor. Specifically, section 2704(b) provides that certain applicable restrictions, which normally justify discounts in the value of the interests transferred, are to be ignored in valuing interests in family-controlled entities if those interests are transferred (by gift or death) to or for the benefit of other family members. Application of these rules generally results in an increase in the transfer tax value of those interests above the price a hypothetical willing buyer would pay a willing seller.

Judicial decisions and enactment of new statutes in many states have made section 2704(b) inapplicable in many situations by recharacterizing restrictions such that they no longer fall within the definition of an applicable restriction.

Proposed Law and Impact
The Obama administration believes it is necessary to create an additional category of restrictions (disregarded restrictions) that would be ignored in 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 transferor and/or the transferor's family. Instead, the transferred interest would be valued by substituting certain assumptions, to be specified in regulations, for the disregarded restrictions.

Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than standards to be identified in regulations. A disregarded restriction would also include any limitation on a transferee's

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ability to be admitted as a full partner or to hold an equity interest in the entity. Additionally, the regulations would provide that certain interests held by charities or other non-family members would be deemed held by the family for purposes of determining whether a restriction may be removed by member(s) of the family after the transfer. The proposal would make conforming clarifications with regard to the interaction of this proposal with the estate and gift tax marital and charitable deductions. These new rules could have a significant impact on the use of family partnerships for tax planning.

This proposal would apply to transfers after the date of enactment of property subject to restrictions (applicable and/or disregarded) created after Oct. 8, 1990.

Require Consistent Valuation for Transfer and Income Tax Purposes

Current Law

Under current law (assumed by the Obama administration to be the same as 2009 law), the basis of property acquired from a decedent is generally the fair market value of the property on the decedent's date of death. Similarly, property included in the decedent's gross estate for estate tax purposes generally must be valued at its fair market value on the date of death.

A donee's basis in property received by gift during the life of the donor is generally the donor's adjusted basis in the property, increased by gift tax paid on the transfer. If, however, the donor's basis exceeds fair market value on the date of gift, the donee's basis is limited to the fair market value.

Current law imposes a consistency requirement, but only for income tax purposes. Specifically, the recipient of a distribution of income from a trust or estate must report on the recipient's own income tax return the exact information included on the Schedule K-1 of the trust's or estate's income tax return. This provision only applies for income tax purposes, and the Schedule K-1 does not include basis information.

Proposed Law and Impact

The Obama administration believes current law allows taxpayers to take inconsistent positions in dealing with the IRS. Specifically, the Obama administration believes the law should require that the new basis of property used to determine a decedent's estate tax liability should also be the value used by the recipient. Furthermore, the Obama administration feels the executor of the estate or the donor is in the best position to ensure the recipient receives the information necessary to determine the recipient's basis in the transferred property.

The proposal would impose both a consistency and a reporting requirement. The basis of property received by reason of death must equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor must equal the donor's basis. The proposal would also require that the basis of property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes, subject to subsequent adjustments.

A reporting requirement would be imposed on the executor of a decedent's estate and on the donor of a lifetime gift to provide the necessary basis information to both the recipient and the IRS. Regulatory authority would be provided to address certain situations, such as in situations when no estate tax return is required to be filed or gifts are excluded from gift tax, situations in which the surviving joint tenant or other recipient may have better information than the executor, and for 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.

The proposal would be effective as of the date of enactment (assuming that law is the same as 2009 law).

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