

**DESCRIPTION OF H.R. 6275, THE “ALTERNATIVE MINIMUM
TAX RELIEF ACT OF 2008”**

Scheduled for Markup
By the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 18, 2008

Prepared by the
Staff of the
JOINT COMMITTEE ON TAXATION



June 17, 2008
JCX-50-08

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INTRODUCTION

The House Committee on Ways & Means has scheduled a markup on June 18, 2008. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of H.R. 6275, the “Alternative Minimum Tax Relief Act of 2008.”

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 6275, the “Alternative Minimum Tax Relief Act of 2008”* (JCX-50-08), June 17, 2008.

I. EXTEND ALTERNATIVE MINIMUM TAX RELIEF FOR INDIVIDUALS

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 amount is: (1) \$66,250 for taxable years beginning in 2007 and \$45,000 in taxable years beginning after 2007 in the case of married individuals filing a joint return and surviving spouses; (2) \$44,350 for taxable years beginning in 2007 and \$33,750 in taxable years beginning after 2007 in the case of other unmarried individuals; (3) \$33,125 for taxable years beginning in 2007 and \$22,500 in taxable years beginning after 2007 in the case of married individuals filing separate returns; and (4) \$22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual’s AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit², the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2008, 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 2007, the nonrefundable personal credits (other than the adoption credit, child credit and saver’s credit) are allowed only to the extent that the individual’s regular income tax liability exceeds the individual’s tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and saver’s credit are allowed to the full extent of the individual’s regular tax and alternative minimum tax.³

² The child credit may be refundable in whole or in part to a taxpayer.

³ The rule applicable to the adoption credit and child credit is subject to the EGTRRA sunset.

Description of Proposal

The proposal provides that the individual AMT exemption amount for taxable years beginning in 2008 is \$69,950, in the case of married individuals filing a joint return and surviving spouses; (2) \$46,200 in the case of other unmarried individuals; and (3) \$34,975 in the case of married individuals filing separate returns.

For taxable years beginning in 2008, the proposal allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective Date

The proposal is effective for taxable years beginning in 2008.

II. REVENUE PROVISIONS

A. Income Of Partners for Performing Investment Management Services Treated as Ordinary Income Received for Performance of Services

Present Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership in exchange for the performance of services has been the subject of controversy. 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.⁴

In 1993, the Internal Revenue Service, referring to the results of 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.⁵ 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 guidance⁶ 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.⁷

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating the receipt of property for the

⁴ Only a handful of cases have ruled on this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T. C. (1971), *aff'd* 492 F. 2d 286 (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)).

⁵ Rev. Proc. 93-27, 1993-2 C.B. 343, citing the *Diamond* and *Campbell* cases, *supra*.

⁶ Rev. Proc. 2001-43 (2001-2 C.B. 191).

⁷ A similar result would occur under the 'safe harbor' election of proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

performance of services.⁸ A partnership capital interest for this purpose is an interest that 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.⁹

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.¹⁰ Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

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

Employment tax treatment of partners

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").¹¹ A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").¹²

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.40 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.¹³ The amount of wages subject to this component is capped at \$102,000 for 2008. Under the hospital insurance component ("HI"), the rate is 2.90 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The

⁸ 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).

⁹ Rev. Proc. 93-27, 1993-2 C.B. 343.

¹⁰ Sec. 702.

¹¹ See Chapter 21 of the Code.

¹² Sec. 1401.

¹³ Secs. 3101 and 3111.

wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.¹⁴

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.40 percent and the amount of earnings subject to this component is capped at \$102,000 (for 2008). Under the HI component, the rate is 2.90 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.¹⁵ Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rents and dividends, as described above). This rule applies to individuals who are general partners. A special rule applies for limited partners of a partnership.¹⁶ In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

¹⁴ 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.

¹⁵ For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes (sec. 164(f)).

¹⁶ Sec. 1402(a)(13).

Income tax treatment of publicly traded partnerships

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

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

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

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

Real estate investment trusts (REITs)

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

A REIT generally is required to distribute 90 percent of its income (other than net capital gain) to its investors before the end of its taxable year.

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the “95-percent income test”). In addition, at least 75 percent of its income generally must be from certain real estate sources (the “75-percent income test”), including rents from real property (as defined) and gain from the sale or other disposition of real property. Amounts received as impermissible “tenant services income” are not treated as rents from real property.¹⁷ In general, such amounts are for services rendered to tenants that are not “customarily furnished” in connection with the rental of real property. In addition, at least 75 percent of the value of its total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities, and maximum percentages apply to ownership of other types of securities (the “asset test”).

Description of Proposal

Recharacterization as ordinary income for performance of services

The proposal generally treats net income from an investment services partnership interest as ordinary income for the performance of services except to the extent it is attributable to the partner’s invested capital. Thus, the proposal recharacterizes the partner’s distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income in the hands of the partner. Such income is taxed at ordinary income rates and is subject to self-employment tax.

Net income means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year. All items of income, gain, deduction, and loss that are taken into account in computing net income (or net loss) are treated as ordinary income (or ordinary loss, as the case may be). Net income from an investment services partnership interest is included in net earnings from self-employment.

The proposal provides that an investment services partnership interest is a partnership interest held by any person who provides (directly or indirectly) a substantial quantity of certain services to the partnership in the conduct of the trade or business of providing such services. The services are: (1) advising the partnership as to the advisability of investing in, purchasing, or

¹⁷ A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

selling any specified asset; (2) managing, acquiring, or disposing of any specified asset; (3) arranging financing with respect to acquiring specified assets; (4) any activity in support of any of the foregoing services.

For this purpose, specified assets means securities (as defined in section 475(c)(2)), real estate, commodities (as defined in section 475(e)(2)), or options or derivative contracts with respect to such securities, real estate, or commodities. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means a (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified.

Exception for invested capital

The proposal provides an exception to recharacterization as ordinary income for performance of services in the case of the portion of the partner's distributive share of partnership items with respect to the partner's invested capital. Invested capital means the fair market value at the time of contribution of any money or other property contributed to the partnership. The exception applies provided that the partnership makes a reasonable allocation of partnership items between the portion of the partner's distributive share attributable to invested capital and the remaining portion. The exception to recharacterization also applies to gain or loss attributable to invested capital on disposition of the partnership interest, which is the portion that would have been allocable to invested capital if the partnership had sold all its assets immediately before the disposition.

An allocation is not treated as reasonable if it would result in the allocation of a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital. In applying this rule, it is intended that the return to the service-providing partner's invested capital (if any) be at no greater a rate than the return to that non-service-providing partner who has the lowest rate of return on his invested capital. For example, assume two partners each contribute \$1 million to a partnership they form, and a third partner who performs services that make his interest an investment services partnership interest also contributes \$500,000 to the partnership. Partnership earnings the following year are \$900,000, and the partnership agreement provides that the earnings are divided equally among the three partners (\$300,000 each). Under the provision, an allocation to the third partner is not treated as reasonable if the amount allocated to his invested capital exceeds \$150,000. The two non-service-providing partners' rates of return on invested capital is 30 percent (\$300,000 earnings on \$1 million), so 30 percent of the service provider's \$500,000 of invested capital is \$150,000.

It is intended that Treasury Department guidance provide that an allocation of income on invested capital does not fail to be treated as reasonable solely because of appreciation or depreciation in the value of partnership capital prior to the admission of new partners (provided service providers do not thereby convert their compensation to income on invested capital). For example, assume two partners, one of whom is a service provider, each contribute \$1 million to a partnership they form, and the partnership assets appreciate to \$6 million, at which time a third partner is admitted for a capital investment of \$3 million. Earnings at the end of the following year are \$900,000, divided equally among the three partners. An allocation of earnings on invested capital to the service-providing partner of \$300,000 should not fail to be treated as reasonable solely because it reflects appreciation in the value of the partnership assets as of the time of admission of the third partner. Such an allocation may fail to be treated as reasonable based on other factors identified in Treasury guidance. In particular, it is not intended that the partner that provides services be permitted to treat any amount as income on invested capital to the extent it otherwise would be treated as compensation under the provision.

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

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

Losses, dispositions, and partnership distributions

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

Consistently with the general rule providing that net income with respect to such a partnership interest is ordinary income for the performance of services, the proposal provides that net loss with respect to such a partnership interest (to the extent not disallowed) generally is treated as ordinary loss. For this purpose, net loss means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year. The net loss is allowed for a partnership taxable year,

however, only to the extent that the loss does not exceed the excess (if any) of (1) aggregate net income with respect to the partnership interest for prior partnership taxable years, over (2) the aggregate net loss with respect to the partnership interest not disallowed for prior partnership years. Any net loss that is not allowed for the partnership taxable year is carried forward to the next partnership taxable year. Notwithstanding the present-law rule that the basis of a partnership interest generally is reduced by the partner's distributive share of partnership losses and deductions (sec. 705(a)(2)), the proposal provides that no adjustment is made to the basis of a partnership interest on account of a net loss that is not allowed for the partnership taxable year. When any such net loss that is carried forward is allowed in a subsequent year, the adjustment is made to the basis of the partnership interest.

For purposes of determining self-employment tax, a net loss from an investment services partnership interest (to the extent it is allowed in computing taxable income) is taken into account in determining net earnings from self-employment for the taxable year. Thus, for example, if an individual has three investment services partnership interests, two of which generate net income for the taxable year and the third of which generates a net loss that is allowable under the provision as an ordinary loss for the taxable year, then the entire net income and net loss are taken into account in determining the individual's net earnings from self-employment for the taxable year. However, to the extent a loss is disallowed under this provision for a taxable year, that loss does not reduce the taxpayer's net earnings from self-employment for that taxable year, but is taken into account in the carryover year for which it is allowed in determining the amount of ordinary compensation under this provision. To the same extent as under present law, the provision does not permit net operating loss deductions in calculating net earnings from self-employment (sec. 1402(a)(4)).

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

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

On the distribution of property by a partnership to a partner with respect to an investment services partnership interest, the provision provides generally that the partner recognizes ordinary compensation income to the extent of any appreciation in the property. Specifically, the provision provides that the excess (if any) of the fair market value of the property at the time of the distribution over the adjusted basis of the distributed property in the hands of the partnership

is included in income by the partner, and is considered ordinary compensation income by reason of the general rule of the provision (new section 710(a)(1)). This amount is not so includable to the extent otherwise taken into account in computing the taxable income of the partnership, for example, by reason of section 751(b), treating certain distributions as sales or exchanges.

To the extent the fair market value of the property (which is treated as money) exceeds the partner's adjusted basis in its partnership interest, the partner has ordinary compensation (secs. 731(a)(1) and 710(a)(1)). The basis of the distributed property is its fair market value at the time of the distribution. The adjusted basis of the distributee partner's interest in the partnership is reduced (but not below zero) under section 733 by the amount of money upon the distribution.

For example, assume a partnership has an adjusted basis of 20 in a property whose fair market value is 50. The partnership distributes the property to a partner whose investment services partnership interest has an adjusted basis of 35. Under the provision, 30 (50 minus 20) is included in the partner's income as compensation. The partner's basis in his investment services partnership interest is increased from 35 to 65 by the 30 of income taken into account and then reduced to 15 by the 50 value of the property distributed. If the partner sells the partnership interest at a gain, the gain is treated as compensation income under the general rule of the provision (new section 710(a)).

So that the other partners' shares of the basis of partnership property are not affected by the property distribution, the present-law rules providing for an adjustment to the basis of the partnership's property in the event of a section 754 election or a substantial basis reduction are applied without regard to the income inclusion rule for property distributions with respect to an investment services partnership interest.

In applying the present-law rules relating to ordinary income treatment of amounts attributable to unrealized receivables and inventory items on sale or exchange of a partnership interest (sec. 751(a)), an investment services partnership interest is treated as an inventory item of the partnership. Thus, for example, upon the sale or exchange of an interest in a partnership that in turn holds an investment services partnership interest, amounts received by the transferor partner that are attributable to the investment services partnership interest are considered as ordinary income.

Other entities

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

This rule applies if (1) a person performs (directly or indirectly) investment management services for any entity, (2) the person holds a disqualified interest with respect to the entity, and (3) the value of the interest (or payments thereunder) is substantially related to the amount of realized or unrealized income or gain from the assets with respect to which the investment management services are performed. In this case, any income or gain with respect to the interest

is treated as ordinary income for the performance of services. Rules similar to the exception for a partner's invested capital apply for this purpose. For this purpose, a disqualified interest in an entity means (1) any interest other than debt, (2) convertible or contingent debt, (3) an option or other right to acquire either of the foregoing, or (4) a derivative instrument entered into (directly or indirectly) with the entity or an investor in the entity. A disqualified interest does not include a partnership interest. A disqualified interest also does not include stock in a taxable corporation, which for this purpose means either a domestic C corporation or a foreign corporation that is subject to a comprehensive foreign income tax. Under this rule, a comprehensive income tax means the income tax of a foreign country if the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between that country and the U.S., or if the corporation demonstrates to the satisfaction of the Treasury Secretary that the foreign country has a comprehensive income tax.

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

Underpayment penalty

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

Self-employment tax treatment

Under the proposal, net income from an investment services partnership interest is subject to self-employment tax. Net income from an investment services partnership interest is derived from the performance by a person of a substantial quantity of services to the partnership in the course of the active conduct of a trade or business. This income falls within the definition of net earnings from self-employment, which generally includes a partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the

partnership (sec. 1402(a)), with certain exclusions. Because net income from an investment services partnership is treated as ordinary income for the performance of services, the present-law exception for gain or loss from the sale or exchange of a capital asset does not apply, even though the net income from the investment service partnership interest might otherwise be characterized as capital gain. The proposal also provides that, in the case of a limited partner, the present-law exclusion for limited partners does not apply to any income treated as ordinary income from an investment services partnership interest that is received by an individual who provides a substantial quantity of the specified services.

Rules relating to REITs and publicly traded partnerships

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

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

The proposal provides a special rule for certain partnerships that are owned by publicly traded REITs and that meet specific requirements, however. Under the special rule, the recharacterization of partnership income as ordinary income for the performance of services does not apply, provided the following requirements are met. The requirements are: (1) the partnership is treated as publicly traded (under section 7704) solely because interests in the partnership are convertible into interests in a publicly traded REIT; (2) 50 percent or more of the capital and profits interests of the partnership are owned, directly or indirectly, at all times during the taxable year, by the REIT (taking into account attribution rules under section 267(c)); and (3) the partnership itself satisfies the REIT income and asset limitations (secs. 856(c)(2), (3), and (4), applied without regard to this proposal). Thus, for example, this special rule provides that a partnership is not treated as a corporation under section 7704, in an “upreit” structure in which a publicly traded REIT owns more than 50 percent of the capital and profits interests of the partnership, partnership interests held by persons other than the REIT are convertible into publicly traded REIT stock, and the partnership itself meets the income and asset limitations of the REIT rules (secs. 856(c)(2), (3) and (4)). For this purpose, if the partnership interest may be put to the REIT or the partnership for REIT stock, it is considered convertible into interests of the publicly traded REIT. It is not intended that convertibility of partnership interests into a class of publicly traded REIT stock that tracks the performance of particular partnership assets (such as assets of a type that, if held in excess, would cause the REIT asset or income limitations not to be satisfied), or performance of the partnership assets generally, satisfies this special rule; rather, it is intended that such a partnership does not meet the requirements of this special rule.

Regulatory authority

The Treasury Department shall prescribe such regulations as are necessary or appropriate to carry out the purpose of the proposal, including regulations to prevent the avoidance of the purposes of the proposal and regulations to coordinate the proposal with other rules of subchapter K of the Code (relating to partnerships). It is not intended that the provision be utilized to effect a recharacterization as untaxed foreign-source compensation income the amount of any otherwise taxable (or withholdable) U.S.-source dividend, effectively connected income, U.S. real property gain, or similar income or of any otherwise taxable subpart F inclusion or passive foreign investment company inclusion; the Treasury Department is directed to provide guidance to carry out this intent.

Effective Date

The proposal is effective generally for taxable years ending after June 18, 2008.

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

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

The proposal relating to income or gain with respect to interests in certain entities other than partnerships that are held by a person who performs, directly or indirectly, investment management services for the entity takes effect on June 18, 2008.

For purposes of applying the rules relating to publicly traded partnerships (section 7704), the proposal applies to taxable years beginning after December 31, 2010.

B. Limitation of Deduction for Income Attributable to Domestic Production of Oil, Gas, or Primary Products Thereof

Present Law

In general

Section 199 of the Code provides a deduction equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 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.¹⁸

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; (2) other expenses, losses, or deductions which are properly allocable to such receipts.

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property ("QPP") that was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film 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;¹⁹ or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

¹⁸ For purposes of the proposal, "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 designated Roth contributions (as defined in section 402A).

¹⁹ 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.

Congress granted Treasury broad authority to “prescribe such regulations as are necessary to carry out the purposes” of section 199.²⁰ In defining MPGE for purposes of section 199, Treasury described the following as MPGE activities: manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals.²¹

The regulations specifically cite an example of oil refining activities in describing the “in whole or in significant part” test in determining domestic production gross receipts. QPP is generally considered to be MPGE in significant part by the taxpayer within the United States if such activities are substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer’s MPGE activity within the United States, the nature of the QPP, and the nature of the MPGE activity that the taxpayer performs within the United States.²² The following example is provided in the regulations to illustrate this “substantial in nature” standard:

X purchases from Y, an unrelated person, unrefined oil extracted outside the United States. X refines the oil in the United States. The refining of the oil by X is an MPGE activity that is substantial in nature.²³

Natural gas transmission or distribution

Domestic production gross receipts include gross receipts from the production in the United States of natural gas, but excludes gross receipts from the transmission or distribution of natural gas.²⁴ Production activities generally include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas. However, gross receipts of a taxpayer attributable to transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company’s citygate (or to another customer) are not qualified domestic production gross receipts. Likewise, gas purchased by a local gas distribution company and distributed from the citygate to the local customers does not give rise to domestic production gross receipts.

²⁰ Sec. 199(d)(9).

²¹ Treas. Reg. sec. 1.199-3(e)(1).

²² Treas. Reg. sec. 1.199-3(g)(2).

²³ Treas. Reg. sec. 1.199-3(g)(5), Example 1.

²⁴ H.R. Rep. No. 108-755 (conference report for the American Jobs Creation Act of 2004), footnote 28 at 272.

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.²⁵ 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.²⁶

Qualifying in-kind partnerships

In general, an owner of a pass-thru 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.²⁷ In the case of a qualifying in-kind partnership, each partner is treated as MPGE or producing the property MPGE or produced by the partnership that is distributed to that partner.²⁸ If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced 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 or production activities previously conducted by the qualifying in-kind partnership with respect to that property.²⁹

Alternative minimum tax

The deduction for domestic production activities is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

²⁵ Treas. Reg. sec. 1.199-3(m)(1)(i).

²⁶ Treas. Reg. sec. 1.199-3(m)(2)(iii).

²⁷ Treas. Reg. sec. 1.199-9(i)(2).

²⁸ Treas. Reg. sec. 1.199-9(i)(1).

²⁹ Id.

Description of Proposal

The proposal excludes gross receipts of any major integrated oil company (as defined in section 167(h)(5)(B)) derived from the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof from the term “domestic production gross receipts” for purposes of section 199. The term “primary product” has the same meaning as when used in section 927(a)(2)(C), as in effect before its repeal. The Treasury regulations define 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.³⁰ 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.³¹ The term “primary product from gas” is defined 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.³² 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.³³ Examples of nonprimary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.³⁴

The proposal also reduces the section 199 deduction for taxpayers, other than major integrated oil companies, that have oil related qualified production activities income for any taxable year beginning after 2009 by three percent of the least of: (1) oil related qualified production activities income for the taxable year; (2) qualified production activities income for the taxable year; or (3) taxable income (determined without regard to the section 199 deduction). The term “oil related qualified production activities income” is defined as the qualified production activities income which is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof during such taxable year.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2008.

³⁰ Treas. Reg. sec. 1.927(a)-1T(g)(2)(i).

³¹ Id.

³² Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii).

³³ Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii).

³⁴ Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv).

C. Limit Tax Treaty Benefits with Respect to Certain Deductible Payments

Present Law

In general

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

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

Tax treaties

A foreign corporation may not benefit from a provision of a U.S. tax treaty with a foreign country that eliminates or reduces U.S. withholding tax unless the foreign corporation is both a resident of such foreign country and qualifies under any limitation-of-benefits provision contained in the U.S. tax treaty with such foreign country. In general, a foreign corporation is a resident of a foreign country under a U.S. tax treaty with that foreign country if it is liable to tax in that country by reason of its domicile, residence, citizenship, place of management, place of incorporation, or other criterion of a similar nature.³⁵

Limitation-on-benefits provisions

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

³⁵ United States Model Income Tax Convention of November 15, 2006, Art. 4, par. 1.

resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made.

U.S. tax treaties contain a variety of limitation-on-benefits provisions due to the continued and recently accelerated development of limitation-on-benefits concepts, and the negotiated nature of tax treaties in general. Although many older U.S. tax treaties may lack limitation-on-benefits provisions³⁶ or lack the refinements now thought essential to such provisions, the U.S. model income tax treaty, as most recently revised in 2006 (“U.S. model treaty”),³⁷ and most of the newer U.S. treaties include limitation-on-benefits provisions that limit treaty benefits to resident taxpayers that meet certain detailed requirements intended to minimize these abuses. Present Treasury Department policy, which has been repeatedly ratified by the Senate, is broadly to revise older treaties by tightening limitation-on-benefits provisions to prevent treaty shopping.

The limitation-on-benefits rules included in U.S. income tax treaties and protocols signed since 2001 generally correspond with the limitation-on-benefits provisions of the U.S. model treaty.³⁸ Certain features of the limitation-on-benefits provisions in recent treaties and protocols, however, differ from the rules in the U.S. model treaty, and some recent treaties and protocols include additional limitation-on-benefits rules not included in the U.S. model treaty. Some of the additions and differences make limitation-on-benefits provisions more restrictive than the rules in the U.S. model treaty, and others make the provisions less restrictive.

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

The limitation-on-benefits rules of the U.S. model treaty include three provisions under which a resident of a treaty country may qualify for treaty benefits. First, a treaty-country

³⁶ U.S. income tax treaties with Greece, Hungary, Iceland, Pakistan, the Philippines, Poland, and Romania are examples of such treaties. The U.S.-Greece treaty entered into force on December 30, 1953; the U.S.-Hungary treaty entered into force on September 18, 1979; the U.S.-Iceland treaty entered into force on December 26, 1975; the U.S.-Pakistan treaty entered into force on May 21, 1959; the U.S.-Philippines treaty entered into force on October 16, 1982; the U.S.-Poland treaty entered into force on July 23, 1976; and the U.S.-Romania treaty entered into force on February 26, 1976.

³⁷ United States Model Income Tax Convention of November 15, 2006, Art. 22.

³⁸ The income tax treaties and protocols signed since 2001 are those with the United Kingdom (treaty entered into force on March 31, 2003); Australia (protocol entered into force May 12, 2003); Mexico (protocol entered into force July 3, 2003); Sri Lanka (protocol entered into force July 12, 2004); Japan (treaty entered into force March 30, 2004); Barbados (protocol entered into force December 20, 2004); Netherlands (protocol entered into force December 28, 2004); Bangladesh (treaty entered into force August 7, 2006); Sweden (protocol entered into force August 31, 2006); France (protocol entered into force December 21, 2006); Denmark (protocol entered into force December 28, 2007); Finland (protocol entered into force December 28, 2007); Germany (protocol entered into force December 28, 2007); Belgium (treaty entered into force December 28, 2007); Bulgaria (treaty signed February 23, 2007; has not yet entered into force); Canada (protocol signed September 21, 2007; has not yet entered into force); and Iceland (treaty signed October 23, 2007; has not yet entered into force).

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

A treaty-country resident may qualify for treaty benefits under the U.S. model treaty if it has one of the following attributes: it is (1) an individual; (2) a contracting state or a political subdivision or a local authority of the contracting state; (3) a company that satisfies public-trading or ownership tests described below; (4) a pension fund or other tax-exempt organization (if, in the case of a pension fund, more than 50 percent of the fund's beneficiaries, members, or participants are individuals resident in either treaty country); or (5) a person other than an individual that satisfies ownership and base-erosion requirements described below.

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

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

Under the U.S. model treaty, a resident of a treaty country that is not eligible for all treaty benefits under any of the rules described above may be entitled to treaty benefits with respect to a particular item of income derived from the other treaty country. A resident is entitled to treaty

benefits for such an income item if the resident is engaged in the active conduct of a trade or business in its country of residence (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer) and the income derived from the other treaty country is derived in connection with or is incidental to that trade or business. If a resident of a treaty country derives an item of income from a trade or business activity that it conducts in the other treaty country, or derives an income item arising in that other country from a related person, the income item eligibility rule just described is considered satisfied for that income item only if the trade or business activity carried on by the resident in its country of residence is substantial in relation to the trade or business activity carried on by the resident or the related person in the other country. The determination whether a trade or business activity is substantial is based on all the facts and circumstances.

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

Description of Proposal

In general, the proposal limits tax treaty benefits with respect to U.S. withholding tax imposed on deductible related-party payments. Under the proposal, the amount of U.S. withholding tax imposed on such a payment may be reduced under any U.S. tax treaty only if U.S. withholding tax would have been reduced under a U.S. tax treaty if the payment had been made directly to the "foreign parent corporation" of the payee. A payment is a deductible related-party payment if it is made directly or indirectly by any entity to any other entity, it is allowable as a deduction, and both entities are members of the same "foreign controlled group of entities."

For purposes of the proposal, a foreign controlled group of entities is a controlled group of corporations, modified as described below, in which the common parent company is a foreign corporation. Such common parent company is referred to as the "foreign parent corporation". A controlled group of corporations consists of a chain or chains of corporations connected through direct stock ownership of at least 80 percent vote or value. For purposes of the proposal, the relevant ownership threshold is lowered from at least 80 percent to more than 50 percent, certain members of the controlled group of corporations that would otherwise be treated as excluded members are not treated as excluded members, and insurance companies are not treated as members of a separate controlled group of corporations. In addition, a partnership or other noncorporate entity is treated as a member of a controlled group of corporations if such entity is controlled by members of the group.

The Secretary may prescribe regulations that are necessary or appropriate to carry out the purposes of the proposal, including regulations providing for the treatment of two or more persons as members of a foreign controlled group of entities if such persons would be the

common parent of such group if treated as one corporation, and regulations providing for the treatment of any member of a foreign controlled group of entities as the common parent of that group if such treatment is appropriate taking into account the economic relationships among the group entities.

For example, under the proposal, a deductible payment made by a U.S. entity to a foreign entity with a foreign parent corporation that is resident in a country with respect to which the United States does not have a tax treaty (or that is resident in a country with a U.S. tax treaty that would not reduce the withholding tax if the payment were made directly to the parent) is always subject to the statutory U.S. withholding tax rate of 30 percent, irrespective of whether the payee is resident of a treaty country. If the foreign parent corporation is resident in a country with respect to which the United States has a tax treaty that would have reduced the statutory U.S. withholding rate on a hypothetical deductible payment of the same type and amount made directly to the foreign parent corporation (regardless of the amount of such reduction), the U.S. withholding rate on the actual deductible payment is the applicable rate under the U.S. tax treaty with the country in which the payee is resident.

Effective Date

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

D. Require Information Reporting on Payment Card and Third Party Payment Transactions

Present Law

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the Internal Revenue Service (“IRS”) determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of \$600 or more made in the course of the payor’s trade or business.³⁹ Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number (“TIN”).

Under present law, any person 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.

Description of Proposal

The proposal requires any payment settlement entity making payment to a participating payee in settlement of reportable transactions to report annually to the IRS and to the participating payee the gross amount of such reportable transactions, as well as the name, address, and TIN of the participating payees. A “reportable transaction” means any payment card transaction and any third party network transaction.

Under the proposal, a “payment settlement entity” means, in the case of a payment card transaction, a merchant acquiring bank and, in the case of a third party network transaction, a third party settlement organization. A “participating payee” means, in the case of a payment card transaction, any person who accepts a payment card as payment and, in the case of a third party network transaction, any person who accepts payment from a third party settlement organization in settlement of such transaction.

For purposes of the reporting requirement, the term “merchant acquiring bank” means the bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transactions. A “payment card transaction” means any transaction in which a payment card is accepted as payment.⁴⁰ A “payment card” is defined as any card (e.g., a credit card or debit card) which is issued pursuant to an agreement or

³⁹ Sec. 6041(a). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

⁴⁰ For this purpose, the acceptance as payment of any account number or other indicia associated with a payment card also qualifies a payment card transaction.

arrangement which provides for: (1) one or more issuers of such cards; (2) a network of persons unrelated to each other, and to the issuer, who agree to accept such cards as payment; and (3) standards and mechanisms for settling the transactions between the merchant acquiring banks and the persons who agree to accept such cards as payment. Thus, under the proposal, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions is required to report to the IRS the business's gross credit card transactions for each calendar year. The bank also is required to provide a copy of the information report to the business.

The proposal also requires reporting on a third party network transaction. The term "third party network transaction" means any transaction which is settled through a third party payment network. A "third party payment network" is defined as any agreement or arrangement: (1) which involves the establishment of accounts with a central organization for the purpose of settling transactions between persons who establish such accounts; (2) which provides standards and mechanisms for settling such transactions; (3) which involves a substantial number of persons (e.g., more than 50) unrelated to such central organization who provide goods or services and who have agreed to settle transactions for the proposal of such goods or services pursuant to such agreement or arrangement; and (4) which guarantees persons providing goods or services pursuant to such agreement or arrangement that such persons will be paid for providing such goods or services. In the case of a third party network transaction, the payment settlement entity is the third party settlement organization, which is defined as the central organization which has the contractual obligation to make payment to participating payees of third party network transactions. Thus, an organization generally is required to report if it provides a network enabling buyers who have established accounts with the organization to transfer funds to sellers who have a contractual obligation to accept payment through the network. However, an organization operating a network which merely processes electronic payments (such as wire transfers and direct deposit payments) between buyers and sellers, but does not have contractual agreements with such buyers and sellers to use such network, is not required to report under the proposal.

A third party payment network does not include any agreement or arrangement which provides for the issuance of payment cards as defined by the proposal. In addition, a third party settlement organization is not required to report if the aggregate value of third party network transactions for the year does not exceed \$10,000 and the aggregate number of such transactions does not exceed 200.

The proposal also imposes reporting requirements on intermediaries who receive payments from a payment settlement entity and distribute such payments to one or more participating payees. The proposal treats such intermediaries as participating payees with respect to the payment settlement entity and as payment settlement entities with respect to the participating payees to whom the intermediary distributes payments. Thus, for example, in the case of a corporation that receives payment from a bank for credit card sales effectuated at the corporation's independently-owned franchise stores, the bank is required to report the gross amount of reportable transactions settled through the corporation (notwithstanding the fact that the corporation does not accept payment cards and would not otherwise be treated as a participating payee). In turn, the corporation, as an intermediary, would be required to report the gross amount of reportable transactions allocable to each franchise store.

If a payment settlement entity contracts with a third party to settle reportable transactions on behalf of the payment settlement entity, the proposal requires the third party to file the annual information return in lieu of the payment settlement entity.

Under the proposal, reportable transactions subject to information reporting generally are subject to backup withholding requirements. Finally, present law penalties relating to the failure to file correct information returns would apply to the new information reporting requirements required under the proposal.

Effective Date

The proposal generally is effective for information returns for reportable transactions for calendar years beginning after December 31, 2010. The amendments to the backup withholding requirements apply to amounts paid after December 31, 2011.

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

Present Law

To facilitate the collection of tax, the IRS can generally levy upon all property and rights to property of a taxpayer.⁴¹ With respect to specified types of recurring payments, the IRS may impose a continuous levy of up to 15 percent of each payment, which generally continues in effect until the liability is paid.⁴² With respect to Federal payments to vendors of goods or services, the continuous levy may be up to 100 percent of each payment.

Description of Proposal

The proposal expands the types of Federal payments subject to the 100 percent continuous levy from vendor payments for goods and services to vendor payments for all property and services.

Effective Date

The proposal is effective for levies approved after the date of enactment.

⁴¹ Sec. 6331.

⁴² Sec. 6331(h).

F. Modifications to Corporate Estimated Tax Payments

Present Law

In general

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”)

TIPRA provided the following special rules:

In case of a corporation with assets of at least \$1 billion, the payments due in July, August, and September, 2012, shall be increased to 106.25 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

In case of a corporation with assets of at least \$1 billion, the payments due in July, August, and September, 2013, shall be increased to 100.75 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

Subsequent legislation

Several public laws have been enacted since TIPRA which further increase the percentage of payments due under each of the two special rules enacted by TIPRA described above.

Description of Proposal

The proposal makes two modifications to the corporate estimated tax payment rules.

First, in case of a corporation with assets of at least \$1 billion, the payments due in July, August, and September, 2013, are increased by 59.5 percentage points of the payment otherwise due and the next required payment shall be reduced accordingly.

Second, in case of a corporation with assets of at least \$1 billion, the increased payments due in July, August, and September, 2012 under the special rules in TIPRA and subsequent legislation are repealed. In effect the general rule is applied (i.e., such corporations are required to make quarterly estimated tax payments based on their income tax liability.)

Effective Date

The proposal is effective on the date of enactment.