TECHNICAL EXPLANATION OF H.R. 4213, THE "TAX EXTENDERS ACT OF 2009," AS INTRODUCED IN THE HOUSE OF REPRESENTATIVES ON DECEMBER 7, 2009

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 4213, the "Tax Extenders Act of 2009," as introduced in the House of Representatives on December 7, 2009.

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TITLE I – GENERAL PROVISIONS

A. Individual Tax Relief

1. Deduction of State and local general sales taxes (sec. 101 of the bill and sec. 164 of the Code)

Present Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004-2009, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

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

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

Explanation of Provision

The present-law provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes is extended for one year (through December 31, 2010).

Effective Date

The provision applies to taxable years beginning after December 31, 2009.

2. Additional standard deduction for State and local real property taxes (sec. 102 of the bill and sec. 63 of the Code)

Present Law

In general

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions. Unless an individual taxpayer elects, no itemized deduction is allowed for the taxable year. The deduction for certain taxes, including income taxes, real property taxes, and personal property taxes, generally is an itemized deduction.[2]

Special rule for State and local property taxes

An individual taxpayer's standard deduction for a taxable year beginning in 2009 is increased by the lesser of (1) the amount allowable[3] to the taxpayer as a deduction for State and local taxes described in section 164(a)(1) (relating to real property taxes), or (2) $500 ($1,000 in the case of a married individual filing jointly). The increased standard deduction is determined by taking into account real estate taxes for which a deduction is allowable to the taxpayer under section 164 and, in the case of a tenant-stockholder in a cooperative housing corporation, real estate taxes for which a deduction is allowable to the taxpayer under section 216. No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction.

Explanation of Provision

The provision extends the additional standard deduction for State and local property taxes for one year so that it is available for taxable years beginning before January 1, 2011.

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[2] If the deduction for State and local taxes is attributable to business or rental income, the deduction is allowed in computing adjusted gross income and therefore is not an itemized deduction.

[3] In the case of an individual taxpayer who does not elect to itemize deductions, although no itemized deductions are allowed to the taxpayer, itemized deductions are nevertheless treated as "allowable." See section 63(e).

Effective Date

The provision applies to taxable years beginning after December 31, 2009.

3. Above-the-line deduction for qualified tuition and related expenses (sec. 103 of the bill and sec. 222 of the Code)

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[4] The term qualified tuition and related expenses is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.[5] The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2009.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,[6] and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.[7] Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is

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[4] Sec. 222.

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

[6] Secs. 222(d)(1) and 25A(g)(2).

[7] Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

Explanation of Provision

The provision extends the qualified tuition deduction for one year so that it is generally available for taxable years beginning before January 1, 2011.

Effective Date

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

4. Deduction for certain expenses of elementary and secondary school teachers (sec. 104 of the bill and sec. 62(a)(2)(D) of the Code)

Present Law

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $166,800 ($83,400 for married individuals filing separate returns) for 2009. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2010, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.[8] To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade twelve teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any

[8] Sec. 62(a)(2)(D).

school that provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2009.

Explanation of Provision

The provision extends the deduction for eligible educator expenses for one year so that it is available for taxable years beginning before January 1, 2011.

Effective Date

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

B. Business Tax Relief

1. Research credit (sec. 111 of the bill and sec. 41 of the Code)

Present Law

General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[9] Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.[10]

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

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2009.[11]

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that

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[9] Sec. 41.

[10] Sec. 41(e).

[11] Sec. 41(h).

period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[12]

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[13] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.[14]

<u>Alternative simplified credit</u>

Taxpayers may elect to claim an alternative simplified credit for qualified research expenses. The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.

<u>Eligible expenses</u>

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the

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

[13] Sec. 41(f)(1).

[14] Sec. 41(f)(3).

taxpayer's behalf (so-called contract research expenses).[15] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[16] In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.[17] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[18] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[19] Taxpayers

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[15] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

[16] Sec. 41(d)(3).

[17] Sec. 41(d)(4).

[18] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

[19] Sec. 280C(c).

may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.[20]

Explanation of Provision

The provision extends the research credit for one year, through December 31, 2010.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2009.

2. Subpart F exception for active financing income (sec. 112 of the bill and secs. 953 and 954 of the Code)

Present Law

Under the subpart F rules,[21] 10-percent-or-greater U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity

[20] Sec. 280C(c)(3).

[21] Secs. 951-964.

contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[22]

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income"). These provisions were enacted in the Taxpayer Relief Act of 1997 as one-year temporary exceptions, and in 1998, 1999, 2002, 2006, and 2008, the provisions were extended, and in some cases, modified.[23]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this

[22] Prop. Treas. Reg. sec. 1.953-1(a).

[23] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277). The Tax Relief Extension Act of 1999 (Pub. L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009. The Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) extended the temporary provisions for one year, for taxable years beginning after 2008 and before 2010.

exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Explanation of Provision

The provision extends for one year (for taxable years beginning before 2011) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

3. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company rules (sec. 113 of the bill and sec. 954(c)(6) of the Code)

Present Law

In general

In general, the rules of subpart F[24] require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include certain income of the CFC (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income of a CFC does not include any item of income from sources within the United States that is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

The "look-through rule"

Under the "look-through rule" (sec. 954(c)(6)), dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as ECI. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-through rule, including such regulations as are appropriate to prevent the abuse of the purposes of such rule.

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[24] Secs. 951-964.

The look-through rule is effective for taxable years of foreign corporations beginning before January 1, 2010, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Explanation of Provision

The provision extends for one year the application of the look-through rule, to taxable years of foreign corporations beginning before January 1, 2011, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

4. Extension of 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant improvements, and qualified retail improvement property (sec. 114 of the bill and sec. 168 of the Code)

Present Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[25] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

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

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[25] Sec. 168.

period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements and qualified restaurant property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2010. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service in 2010 and later will be subject to the general rules described above.

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

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

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2010. Qualified restaurant property is any section 1250 property that is a building (if the building is placed in service before January 1, 2010) or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.[26] Qualified restaurant property is recovered using the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for bonus depreciation.[27] Restaurant property placed in service in 2010 and later will be subject to the general rules described above.

Qualified retail property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period and for qualified retail improvement property placed in service after December 31, 2008 and before January 1,

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[26] Sec. 168(e)(7)((A).

[27] Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

2010. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public[28] and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. It is generally intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail property is not eligible for bonus depreciation.[29] Retail property placed in service in 2010 and later will be subject to the general rules described above.

Explanation of Provision

The present law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property are extended for one year (through December 31, 2010).

Effective Date

The provision is effective for property placed in service after December 31, 2009.

5. Seven-year cost recovery period for motorsports racing track facilities (sec. 115 of the bill and sec. 168 of the Code)

Present Law

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

[28] Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

[29] Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.

("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[30] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years. Additionally, a motorsports entertainment complex placed in service before December 31, 2009 is assigned a recovery period of seven years.[31] For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land that during the 36 month period following its placed in service date it hosts a racing event.[32] The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands).

Explanation of Provision

The provision extends the present law seven-year recovery period for one year (to apply to property placed in service before January 1, 2011).

Effective Date

The provision is effective for property placed in service after December 31, 2009.

6. Railroad track maintenance credit (sec. 116 of the bill and sec. 45G of the Code)

Present Law

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during the taxable year.[33] The credit is limited to the product of $3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.[34] Each mile of railroad track may be taken into account only once, either by the

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[30] Sec. 168.

[31] Sec. 168(e)(3)(C)(ii).

[32] Sec. 168(i)(15).

[33] Sec. 45G(a).

[34] Sec. 45G(b)(1).

owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit may also reduce a taxpayer's tax liability below its tentative minimum tax.[35]

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).[36]

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.[37]

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.[38]

The provision applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning before January 1, 2010.

Explanation of Provision

The provision extends the present law credit for one year, for qualified railroad track maintenance expenditures paid or incurred before January 1, 2011.

Effective Date

The provision is effective for expenses paid or incurred in taxable years beginning after December 31, 2009.

7. Special expensing rules for certain film and television productions (sec. 117 of the bill and sec. 181 of the Code)

Present Law

The modified accelerated cost recovery system ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of

35 Sec. 38(c)(4).

36 Sec. 45G(d).

37 Sec. 45G(c).

38 Sec. 45G(e)(1).

years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Under section 181, taxpayers may elect[39] to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2010, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[40] Taxpayers may elect to deduct up to $15 million of the aggregate cost of the film or television production under this section.[41] The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[42]

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[43] The term "compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)).[44] With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes

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[39] See Treas. Reg. section 1.181-2T for rules on making an election under this section.

[40] For this purpose, a production is treated as commencing on the first date of principal photography.

[41] Sec. 181(a)(2)(A).

[42] Sec. 181(a)(2)(B).

[43] Sec. 181(d)(3)(A).

[44] Sec. 181(d)(3)(B).

qualify under the provision.[45] Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.[46]

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.[47]

Explanation of the Provision

The provision extends the present law expensing provision for one year, to qualified film and television productions commencing prior to January 1, 2011.

Effective Date

The provision applies to qualified film and television productions commencing after December 31, 2009.

8. Expensing of environmental remediation costs (sec. 118 of the bill and sec. 198 of the Code)

Present Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[48] Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2010, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.[49] The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for

[45] Sec. 181(d)(2)(B).

[46] Sec. 181(d)(2)(C).

[47] Sec. 1245(a)(2)(C).

[48] Sec. 162.

[49] Sec. 198.

the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in Commissioner v. Idaho Power Co.[50] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA")[51] cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3) of the Code.

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

Section 1400N(g) permits the expensing of environmental remediation expenditures paid or incurred before January 1, 2010, to abate contamination at qualified contaminated sites located in the Gulf Opportunity Zone.

Explanation of Provision

The provision extends the present law expensing provision for one year to include expenditures paid or incurred before January 1, 2011.

Effective Date

The provision is effective for expenditures paid or incurred after December 31, 2009.

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50 418 U.S. 1 (1974).

51 Pub. L. No. 96-510 (1980).

9. Mine rescue team training credit (sec. 119 of the bill and sec. 45N of the Code)

Present Law

As part of the general business credit, an eligible employer may claim a credit with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of such qualified mine rescue team employee, including wages of the employee while attending the program; or (2) $10,000.[52] A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20 hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.[53]

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States.[54] The term "wages" has the meaning given to such term by section 3306(b) (determined without regard to any dollar limitation contained in that section).[55]

No deduction is allowed for the portion of the expenses otherwise deductible which is equal to the amount of the credit.[56] The credit does not apply to taxable years beginning after December 31, 2009.

Explanation of Provision

The provision extends the credit for one year. Under the provision, the credit does not apply to taxable years beginning after December 31, 2010.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

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[52] Sec. 45N(a).

[53] Sec. 45N(b).

[54] Sec. 45N(c).

[55] Sec. 45N(d).

[56] Sec. 280C(e).

10. Election to expense advanced mine safety equipment (sec. 120 of the bill and sec. 179E of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS").[57] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. Present law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2009 is $250,000 of the cost of the qualifying property for the taxable year.[58] For taxable years beginning in 2010, the limitation is $125,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. For taxable years beginning in 2009, the $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000. The reduction amount is $500,000 for taxable years beginning in 2010. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning in 2010.

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.[59] "Qualified advanced mine safety equipment property" means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service before January 1, 2010.[60]

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication

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[57] Sec. 168.

[58] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A) and a renewal community (sec. 1400J).

[59] Sec. 179E(a).

[60] Secs. 179E(c) and (g).

with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.[61]

The portion of the cost of any property with respect to which an expensing election under section 179 is made may not be taken into account for purposes of the 50-percent deduction under section 179E.[62] In addition, a taxpayer making an election under section 179E must file with the Secretary a report containing information with respect to the operation of the mines of the taxpayer as required by the Secretary.[63]

Explanation of Provision

The provision extends for one year, to December 31, 2010, the placed in service termination date for the present-law rule relating to expensing of mine safety equipment.

Effective Date

The provision applies to property placed in service after December 31, 2009.

11. Employer wage credit for employees who are active duty members of the uniformed services (sec. 121 of the bill and sec. 45P of the Code)

Present Law

In general, compensation paid by an employer to an employee is deductible by the employer under section 162(a)(1), unless the expense must be capitalized. In the case of an employee who is called to active duty to the uniformed services of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service and the amount of pay received by the employee from the military (such payments are commonly referred to as "differential wage payments").

If a taxpayer qualifies as an eligible small business employer, the taxpayer may take a credit against the taxpayer's income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the taxpayer's qualified employees for the taxable year.

[61] Sec. 179E(d).

[62] Sec. 179E(e).

[63] Sec. 179E(f).

An eligible small business employer means, with respect to a taxable year, any taxpayer which: (1) employed on average less than 50 employees on business days during the taxable year; and (2) under a written plan of the taxpayer, provides eligible differential wage payments to every qualified employee of the taxpayer. Taxpayers under common control are aggregated for purposes of determining whether a taxpayer is an eligible small business employer.

Differential wage payments means any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer. The term eligible differential wage payments means so much of the differential wage payments paid to a qualified employee as does not exceed $20,000.

A qualified employee of a taxpayer is a person who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

No deduction may be taken for that portion of compensation which is equal to the credit. In addition, the amount of any other credit otherwise allowable under Chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes) of the Code with respect to compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to such employee. The differential wage payment credit is part of the general business credit, and thus this credit is subject to the rules applicable to business credits. For example, an unused credit generally may be carried back to the taxable year that precedes an unused credit year or carried forward to each of the 20 taxable years following the unused credit year.[64] The credit is not allowable against a taxpayer's alternative minimum tax liability.

The credit is not available with respect to a taxpayer who has failed to comply with the employment and reemployment rights of members of the uniformed services (as provided under Chapter 43 of Title 38 of the U.S. Code).

The differential wage payment credit is not available for payments made after December 31, 2009.

Explanation of Provision

The provision extends for one year the differential wage payment credit for employees who are active duty members of the uniformed services. Thus, the differential wage payment credit is available for payments made before January 1, 2011.

[64] A credit that is included in the general business credit cannot be carried back to a tax year before the first tax year for which that component credit is allowable under the effective date of that component credit. Unlike many of the other credits that are included in the general business credit, the differential wage payment credit is not a "qualified business credit" under section 196(c). Thus, a taxpayer cannot deduct under section 196(c) any differential wage payment credits that remain unused at the end of the 20-year carry forward period.

Effective Date

The provision is effective with respect to payments made after December 31, 2009.

12. Certain farming business machinery and equipment treated as 5-year property (sec. 122 of the bill and sec. 168 of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS").[65] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[66] Asset class 01.1 includes machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agricultural, animal husbandry, and horticultural services. These assets are assigned a class life of 10 years and a recovery period of seven years.

However, Section 168(e)(3)(C)(vii) provides a statutory 5-year recovery period for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business and placed in service before January 1, 2010, and the original use of which commences with the taxpayer after December 31, 2008. For these purposes, the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.[67] A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.[68]

Explanation of Provision

The provision extends the 5-year recovery period for one year (to apply to property placed in service before January 1, 2011).

Effective Date

The provision is effective for property placed in service after December 31, 2009.

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[65] Sec. 168.

[66] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[67] Treas. Reg. sec. 1.263A-4(a)(4)(i).

[68] Treas. Reg. sec. 1.263A-4(a)(4)(ii).

13. Treatment of certain dividends of regulated investment companies (sec. 123 of the bill and sec. 871(k) of the Code)

Present Law[69]

In general

A regulated investment company ("RIC") is an entity that meets certain requirements, including a requirement that its income generally be derived from passive investments such as dividends and interest, that it distribute 90 percent of its income, and that elects to be taxed under a special tax regime. Unlike an entity taxed as a corporation, an entity that is taxed as a RIC can deduct amounts paid to its shareholders as dividends. In this manner, tax on RIC income is generally not paid by the RIC but rather by its shareholders. However, income of a RIC is treated as a dividend by those shareholders, unless other special rules apply. Dividends received by foreign persons from a RIC are generally subject to gross-basis tax under sections 871(a) or 881, and the RIC payor of such dividends is obligated to withhold such tax under sections 1441 and 1442.

Under present law, a RIC that earns certain interest income that would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally can treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had earned the interest directly. Also, subject to certain requirements, the RIC is exempt from withholding the gross basis tax on such dividends. Similar rules apply with respect to the designation of certain short term capital gain dividends. However, these provisions relating to certain dividends with respect to interest income and short term capital gain of the RIC do not apply to dividends with respect to any taxable year of a RIC beginning after December 31, 2009.

Explanation of Provision

The provision extends the rules exempting from gross basis tax and from withholding tax the interest-related dividends and to short term capital gain dividends received from a RIC, to dividends with respect to taxable years of a RIC beginning before January 1, 2011.

Effective Date

The provision applies to dividends paid with respect to any taxable year of the RIC beginning after December 31, 2009 (but before January 1, 2011).

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[69] Secs. 871(k), 881, 1441 and 1442.

14. Special rule for regulated investment company stock held in the estate of a nonresident non-citizen (sec. 124 of the bill and sec. 2105 of the Code)

Present Law

The gross estate of a decedent who was a U.S. citizen or resident generally includes all property – real, personal, tangible, and intangible – wherever situated.[70] The gross estate of a nonresident non-citizen decedent, by contrast, generally includes only property that at the time of the decedent's death is situated within the United States.[71] Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments, but does not include either bank deposits or portfolio obligations the interest on which would be exempt from U.S. income tax under section 871.[72] Stock owned and held by a nonresident non-citizen generally is treated as property within the United States if the stock was issued by a domestic corporation.[73]

Treaties may reduce U.S. taxation of transfers of the estates of nonresident non-citizens. Under recent treaties, for example, U.S. tax generally may be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Although stock issued by a domestic corporation generally is treated as property within the United States, stock of a regulated investment company ("RIC") that was owned by a nonresident non-citizen is not deemed property within the United States in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (the "estate tax look-through rule for RIC stock").[74] This estate tax look-through rule for RIC stock does not apply to estates of decedents dying after December 31, 2009.

Explanation of Provision

The provision permits the estate tax look-through rule for RIC stock to apply to estates of decedents dying before January 1, 2011.

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[70] Sec. 2031. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA's rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

[71] Sec. 2103.

[72] Secs. 2104(c), 2105(b).

[73] Sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

[74] Sec. 2105(d).

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

15. Treatment of RICs as "qualified investment entities" under section 897 (FIRPTA) (sec. 125 of the bill and sec. 897 of the Code)

Present law

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

A USRPI includes stock or a beneficial interest in any U.S. real property holding corporation (as defined), with the exception of a domestically controlled "qualified investment entity." A distribution from a "qualified investment entity" that is attributable to the sale of a USRPI is also subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United Sates and the recipient foreign corporation or nonresident alien individual did not hold more than 5 percent of that class of stock or beneficial interest within the 1-year period ending on the date of distribution. Special rules apply to situations involving tiers of qualified investment entities.

The term "qualified investment entity" includes a regulated investment company ("RIC") that meets certain requirements, although the inclusion of a RIC in that definition is scheduled to expire, for certain purposes, on December 31, 2009.[75]

Explanation of Provision

The provision extends the inclusion of a RIC within the definition of a "qualified investment entity" under section 897 of the Code through December 31, 2010, for those situations in which that that inclusion would otherwise expire at the end of 2009.

Effective Date

The provision applies to distributions made after December 31, 2009.

[75] Section 897(h).

16. Suspension of limitation on percentage depletion for oil and gas from marginal wells (sec. 126 of the bill and sec. 613A of the Code)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[76] Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[77] Generally, under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year.[78] The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").[79] The 100-percent net-income limitation for marginal production has been suspended for taxable years beginning before January 1, 2010.

Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).[80]

Explanation of Provision

The provision extends the suspension of the 100-percent net-income limitation for marginal production for one year (to apply to tax years beginning before January 1, 2011).

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[76] Secs. 611-613.

[77] Sec. 613A.

[78] Sec. 613A(c).

[79] Sec. 613(a).

[80] The American Petroleum Institute gravity, or API gravity, is a measure of how heavy or light a petroleum liquid is compared to water.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

C. Charitable Provisions

1. Contributions of capital gain real property made for conservation purposes (sec. 131 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[81]

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

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

Capital gain property

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

[81] Secs. 170, 2055, and 2522, respectively.

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

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

Qualified conservation contributions

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

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

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

In general

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005,[82] the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of

[82] Sec. 170(b)(1)(E).

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

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

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

Farmers and ranchers

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

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

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[83]

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

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

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[83] Sec. 170(b)(2)(B).

Termination

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2009.[84]

Explanation of Provision

The Act extends the special rule regarding contributions of capital gain real property for conservation purposes for one year for contributions made in taxable years beginning before January 1, 2011.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

2. Enhanced charitable deduction for contributions of food inventory (sec. 132 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions in general

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization (sec. 170).

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

General rules regarding contributions of food inventory

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

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of

[84] Secs. 170(b)(1)(E)(vi) and 170(b)(2)(B)(iii).

fair market value in excess of basis) or (2) two times basis.[85] In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.[86] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.[87] Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.[88]

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

Under a special temporary provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory.[89] For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for

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[85] Sec. 170(e)(3).

[86] Sec. 170(b)(2).

[87] Treas. Reg. sec. 1.170A-4A(c)(3).

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

[89] Sec. 170(e)(3)(C).

donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.[90]

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

The temporary provision does not apply to contributions made after December 31, 2009.

Explanation of Provision

The provision extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2011.

Effective Date

The provision is effective for contributions made after December 31, 2009.

3. Enhanced charitable deduction for contributions of book inventories to public schools (sec. 133 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions in general

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization (sec. 170).

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution,

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

would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

General rules regarding contributions of food inventory

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

In general, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[91] In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.[92] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.[93] Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

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

Special rule expanding and modifying the enhanced deduction for contributions of book inventory

The generally applicable enhanced deduction for C corporations is expanded and modified to include certain qualified book contributions made after August 28, 2005, and before

[91] Sec. 170(e)(3).

[92] Sec. 170(b)(2).

[93] Treas. Reg. sec. 1.170A-4A(c)(3).

January 1, 2010.[94] A qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction for qualified book contributions is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs. The donee also must make the certifications required for the generally applicable enhanced deduction, i.e., the donee will (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

Explanation of Provision

The provision extends the expansion of, and modifications to, the enhanced deduction for contributions of book inventory to contributions made before January 1, 2011.

Effective Date

The provision is effective for contributions made after December 31, 2009.

4. Enhanced charitable deduction for corporate contributions of computer technology and equipment for educational purposes (sec. 134 of the bill and sec. 170 of the Code)

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[95]

Under present law, a taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified computer contribution."[96] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of

[94] Sec. 170(e)(3)(D).

[95] Sec. 170(e)(1).

[96] Secs. 170(e)(4) and 170(e)(6).

basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2009.[97]

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed or assembled the property, not later than the date construction or assembly of the property is substantially completed.[98] The original use of the property must be by the donor or the donee,[99] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed or assembled by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[100]

Explanation of Provision

The provision extends the enhanced deduction for computer technology and equipment to contributions made during taxable years beginning after December 31, 2009, and before January 1, 2011.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

5. Tax-free distributions from individual retirement plans for charitable purposes (sec. 135 of the bill and sec. 408 of the Code)

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of

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[97] Sec. 170(e)(6)(G).

[98] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[99] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[100] Sec. 170(e)(6)(C).

withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[101] or to a Federal, State, or local governmental entity for exclusively public purposes.[102] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[103]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[104]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[105] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the

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[101] Secs. 170(c)(3)-(5).

[102] Sec. 170(c)(1).

[103] Secs. 170(b) and (e).

[104] Sec. 170(a).

[105] Sec. 170(f)(8). For any contribution of a cash, check, or other monetary gift, no deduction is allowed unless the donor maintains as a record of such contribution a bank record or written communication from the donee charity showing the name of the donee organization, the date of the contribution, and the amount of the contribution. Sec. 170(f)(17).

goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.[106]

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

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

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2009 is $166,800 ($83,400 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. From 2006 through 2009, the overall limitation on itemized deductions phases out for all taxpayers. The overall limitation on itemized deductions was reduced by one-third in taxable years beginning in 2006 and 2007, and is reduced by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[107] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[108] For

[106] Sec. 6115.

[107] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[108] Sec. 170(f)(2).

such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

<u>IRA rules</u>

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70-½.[109]

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

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[110] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.[111] Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

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[109] Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

[110] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

[111] Sec. 3405.

Qualified charitable distributions

Present law provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.[112] The exclusion may not exceed $100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2)). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½.

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

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

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

The exclusion for qualified charitable distributions applies to distributions made in taxable years beginning after December 31, 2005. Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2009.

[112] The exclusion does not apply to distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

Explanation of Provision

The provision extends the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2009, and before January 1, 2011.

Effective Date

The provision is effective for distributions made in taxable years beginning after December 31, 2009.

6. Modification of tax treatment of certain payments to controlling exempt organizations (sec. 136 of the bill and sec. 512 of the Code)

Present Law

In general, organizations exempt from Federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[113] In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.[114]

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. In general, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). However, a special rule provides that, for payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (i.e., at arm's length).[115] In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section

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[113] Sec. 511.

[114] Sec. 512(b).

[115] Sec. 512(b)(13)(E).

512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

The special rule does not apply to payments received or accrued after December 31, 2009.

Explanation of Provision

The provision extends the special rule to payments received or accrued before January 1, 2011. Accordingly, under the provision, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of section 482 (i.e., at arm's length). Any such excess is subject to a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

Effective Date

The provision is effective for payments received or accrued after December 31, 2009.

7. Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income (sec. 137 of the bill and secs. 512 and 514 of the Code)

Present Law

Taxation of unrelated business income, in general

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes. Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include: (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption; (2)

obligations to pay certain types of annuities; (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons; or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property.

Special rules apply in the case of an exempt organization that owns an interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

Special rules for certain qualifying brownfield properties

In general

Section 512(b)(19) provides a special exclusion from unrelated business taxable income for the gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property by an eligible taxpayer. The exclusion from unrelated business taxable income generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. In addition, present law provides an exception from the debt-financed property rules for such properties.

In order to qualify for the exclusions from unrelated business income and the debt-financed property rules, the eligible taxpayer is required to: (a) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (b) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (c) transfer the remediated site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for purposes of Federal income tax law.[116]

The special exclusion applies only to gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009.[117]

Qualifying brownfield properties

The exclusion from unrelated business taxable income applies only to real property that constitutes a qualifying brownfield property. A qualifying brownfield property means real property that is certified, before the taxpayer incurs any eligible remediation expenditures (other than to obtain a Phase I environmental site assessment), by an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located as a brownfield

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[116] A person is related to another person if (1) such person bears a relationship to such other person that is described in section 267(b) (determined without regard to paragraph (9)), or section 707(b)(1), determined by substituting 25 percent for 50 percent each place it appears therein; or (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

[117] Sec. 512(b)(19)(K).

site within the meaning of section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (as in effect on the date of enactment of the provision). The taxpayer's request for certification must include a sworn statement of the taxpayer and supporting documentation of the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property (including a Phase I environmental site assessment and, if applicable, evidence of the property's presence on a local, State, or Federal list of brownfields or contaminated property) and other environmental assessments prepared or obtained by the taxpayer.

Eligible taxpayer

An eligible taxpayer with respect to a qualifying brownfield property is an organization exempt from tax under section 501(a) that acquired such property from an unrelated person and paid or incurred a minimum amount of eligible remediation expenditures with respect to such property. The exempt organization (or the qualifying partnership of which it is a partner) is required to pay or incur eligible remediation expenditures with respect to a qualifying brownfield property in an amount that exceeds the greater of: (a) $550,000; or (b) 12 percent of the fair market value of the property at the time such property is acquired by the taxpayer, determined as if the property were not contaminated.

An eligible taxpayer does not include an organization that is: (1) potentially liable under section 107 of CERCLA with respect to the property; (2) affiliated with any other person that is potentially liable thereunder through any direct or indirect familial relationship or any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to a qualifying brownfield property is conveyed or financed by a contract of sale of goods or services); or (3) the result of a reorganization of a business entity which was so potentially liable.[118]

Qualified sale, exchange, or other disposition

A sale, exchange, or other disposition of a qualifying brownfield property is considered qualified if such property is transferred by the eligible taxpayer to an unrelated person, and within one year of such transfer the taxpayer has received a certification (a "remediation certification") from the Environmental Protection Agency or an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located that, as a result of the taxpayer's remediation actions, such property would not be treated as a qualifying brownfield

[118] In general, a person is potentially liable under section 107 of CERCLA if: (1) it is the owner and operator of a vessel or a facility; (2) at the time of disposal of any hazardous substance it owned or operated any facility at which such hazardous substances were disposed of; (3) by contract, agreement, or otherwise it arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances; or (4) it accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance. 42 U.S.C. sec. 9607(a) (2004).

property in the hands of the transferee. A taxpayer's request for a remediation certification must be made no later than the date of the transfer and must include a sworn statement by the taxpayer certifying that: (1) remedial actions that comply with all applicable or relevant and appropriate requirements (consistent with section 121(d) of CERCLA) have been substantially completed, such that there are no hazardous substances, pollutants or contaminants that complicate the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property; (2) the reasonably anticipated future land uses or capacity for uses of the property are more economically productive or environmentally beneficial than the uses of the property in existence on the date the property was certified as a qualifying brownfield property;[119] (3) a remediation plan has been implemented to bring the property in compliance with all applicable local, State, and Federal environmental laws, regulations, and standards and to ensure that remediation protects human health and the environment; (4) the remediation plan, including any physical improvements required to remediate the property, is either complete or substantially complete, and if substantially complete,[120] sufficient monitoring, funding, institutional controls, and financial assurances have been put in place to ensure the complete remediation of the site in accordance with the remediation plan as soon as is reasonably practicable after the disposition of the property by the taxpayer; and (5) public notice and the opportunity for comment on the request for certification (in the same form and manner as required for public participation required under section 117(a) of CERCLA (as in effect on the date of enactment of the provision)) was completed before the date of such request. Public notice must include, at a minimum, publication in a major local newspaper of general circulation.

Eligible remediation expenditures

Eligible remediation expenditures means, with respect to any qualifying brownfield property: (1) expenditures that are paid or incurred by the taxpayer to an unrelated person to obtain a Phase I environmental site assessment of the property; (2) amounts paid or incurred by the taxpayer after receipt of the certification that the property is a qualifying brownfield property for goods and services necessary to obtain the remediation certification; and (3) expenditures to obtain remediation cost-cap or stop-loss coverage, re-opener or regulatory action coverage, or similar coverage under environmental insurance policies,[121] or to obtain financial guarantees required to manage the remediation and monitoring of the property. Eligible remediation expenditures include expenditures to: (1) manage, remove, control, contain, abate, or otherwise remediate a hazardous substance, pollutant, or contaminant on the property; (2) obtain a Phase II environmental site assessment of the property, including any expenditure to monitor, sample,

[119] For this purpose, use of the property as a landfill or other hazardous waste facility shall not be considered more economically productive or environmentally beneficial.

[120] For these purposes, substantial completion means any necessary physical construction is complete, all immediate threats have been eliminated, and all long-term threats are under control.

[121] Cleanup cost-cap or stop-loss coverage is coverage that places an upper limit on the costs of cleanup that the insured may have to pay. Re-opener or regulatory action coverage is coverage for costs associated with any future government actions that require further site cleanup, including costs associated with the loss of use of site improvements.

study, assess, or otherwise evaluate the release, threat of release, or presence of a hazardous substance, pollutant, or contaminant on the property; or (3) obtain environmental regulatory certifications and approvals required to manage the remediation and monitoring of the hazardous substance, pollutant, or contaminant on the property. Eligible remediation expenditures do not include: (1) any portion of the purchase price paid or incurred by the eligible taxpayer to acquire the qualifying brownfield property; (2) environmental insurance costs paid or incurred to obtain legal defense coverage, owner/operator liability coverage, lender liability coverage, professional liability coverage, or similar types of coverage;[122] (3) any amount paid or incurred to the extent such amount is reimbursed, funded or otherwise subsidized by: (a) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the property; (b) proceeds of an issue of State or local government obligations used to provide financing for the property, the interest of which is exempt from tax under section 103; or (c) subsidized financing provided (directly or indirectly) under a Federal, State, or local program in connection with the property; or (4) any expenditure paid or incurred before the date of enactment of the provision.

Qualified gain or loss

Section 512(b)(19) generally excludes from unrelated business taxable income the exempt organization's gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property. Income, gain, or loss from other transfers does not qualify under the provision.[123] The amount of gain or loss excluded from unrelated business taxable income is not limited to or based upon the increase or decrease in value of the property that is attributable to the taxpayer's expenditure of eligible remediation expenditures. Further, the exclusion does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including any amount deducted as a section 198 expense that is subject to the recapture rules of section 198(e), if the taxpayer had deducted such amount in the computation of its unrelated business taxable income.[124]

Special rules for qualifying partnerships

In the case of a tax-exempt organization that is a partner of a qualifying partnership that acquires, remediates, and disposes of a qualifying brownfield property, the provision applies to the tax-exempt partner's distributive share of the qualifying partnership's gain or loss from the

[122] For this purpose, professional liability insurance is coverage for errors and omissions by public and private parties dealing with or managing contaminated land issues, and includes coverage under policies referred to as owner-controlled insurance. Owner/operator liability coverage is coverage for those parties that own the site or conduct business or engage in cleanup operations on the site. Legal defense coverage is coverage for lawsuits associated with liability claims against the insured made by enforcement agencies or third parties, including by private parties.

[123] For example, rent income from leasing the property does not qualify.

[124] Depreciation or section 198 amounts that the taxpayer had not used to determine its unrelated business taxable income are not treated as gain that is ordinary income under sections 1245 or 1250 (secs. 1.1245-2(a)(8) and 1.1250-2(d)(6)), and are not recognized as gain or ordinary income upon the sale, exchange, or disposition of the property. Thus, an exempt organization would not be entitled to a double benefit resulting from a section 198 expense deduction and the proposed exclusion from gain with respect to any amounts it deducts under section 198.

disposition of the property.[125] A qualifying partnership is a partnership that: (1) has a partnership agreement that satisfies the requirements of section 514(c)(9)(B)(vi) at all times beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property; (2) satisfies the requirements of the provision if such requirements are applied to the partnership (rather than to the eligible taxpayer that is a partner of the partnership); and (3) is not an organization that would be prevented from constituting an eligible taxpayer by reason of it or an affiliate being potentially liable under CERCLA with respect to the property.

The exclusion is available to a tax-exempt organization with respect to a particular property acquired, remediated, and disposed of by a qualifying partnership only if the exempt organization is a partner of the partnership at all times during the period beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property, and ending on the date of the disposition of the property by the partnership.

If the property is acquired and remediated by a qualifying partnership of which the exempt organization is a partner, it is intended that the certification as to status as a qualified brownfield property and the remediation certification will be obtained by the qualifying partnership, rather than by the tax-exempt partner, and that both the eligible taxpayer and the qualifying partnership will be required to make available such copies of the certifications to the IRS. Any elections or revocations regarding the application of the eligible remediation expenditure rules to multiple properties (as described below) acquired, remediated, and disposed of by a qualifying partnership must be made by the partnership. A tax-exempt partner is bound by an election made by the qualifying partnership of which it is a partner.

Special rules for multiple properties

The eligible remediation expenditure determinations generally are made on a property-by-property basis. An exempt organization (or a qualifying partnership of which the exempt organization is a partner) that acquires, remediates, and disposes of multiple qualifying brownfield properties, however, may elect to make the eligible remediation expenditure determinations on a multiple-property basis. In the case of such an election, the taxpayer satisfies the eligible remediation expenditures test with respect to all qualifying brownfield properties acquired during the election period if the average of the eligible remediation expenditures for all such properties exceeds the greater of: (a) $550,000; or (b) 12 percent of the average of the fair market value of the properties, determined as of the dates they were acquired by the taxpayer and as if they were not contaminated. If the eligible taxpayer elects to make the eligible remediation expenditure determination on a multiple property basis, then the election shall apply to all qualifying sales, exchanges, or other dispositions of qualifying brownfield properties the acquisition and transfer of which occur during the period for which the election remains in effect.[126]

[125] The exclusions do not apply to a tax-exempt partner's gain or loss from the tax-exempt partner's sale, exchange, or other disposition of its partnership interest. Such transactions continue to be governed by prior law.

[126] If the taxpayer fails to satisfy the averaging test for the properties subject to the election, then the taxpayer may not apply the exclusion on a separate property basis with respect to any of such properties.

Debt-financed property

The present law provision provides that debt-financed property, as defined by section 514(b), does not include any property the gain or loss from the sale, exchange, or other disposition of which is excluded by reason of the provisions of the provision that exclude such gain or loss from computing the gross income of any unrelated trade or business of the taxpayer. Thus, gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property that otherwise satisfies the requirements of the provision is not taxed as unrelated business taxable income merely because the taxpayer incurred debt to acquire or improve the site.

Termination date

As noted above, only gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009, is eligible for the special exclusion. Property acquired during the five-year acquisition period need not be disposed of by the termination date in order to qualify for the exclusion. For purposes of the multiple property election, gain or loss on property acquired after December 31, 2009, is not eligible for the exclusion from unrelated business taxable income, although properties acquired after the termination date (but during the election period) are included for purposes of determining average eligible remediation expenditures.

Explanation of Provision

The provision extends the special exclusion from unrelated business taxable income to properties acquired by an eligible taxpayer or qualifying partnership before January 1, 2011.

Effective Date

The provision is effective for property acquired after December 31, 2009.

8. Basis adjustment to stock of S corporations making charitable contributions of property (sec. 138 of the bill and sec. 1367 of the Code)

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[127] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[128]

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[127] Sec. 1366(a)(1)(A).

[128] Sec. 1367(a)(2)(B).

In the case of contributions made in taxable years beginning before January 1, 2010, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2009, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

Explanation of Provision

The provision extends the rule relating to the basis reduction on account of charitable contributions of property for one year to contributions made in taxable years beginning before January 1, 2011.

Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2009.

D. Miscellaneous Provisions

1. Indian employment tax credit (sec. 141 of the bill and sec. 45A of the Code)

Present Law

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees.[129] The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

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

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of $30,000 (which after adjusted for inflation is currently $45,000 for 2009). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a five percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred in taxable years that begin before January 1, 2010.

[129] Sec. 45A.

Explanation of Provision

The provision extends for one year the present-law employment credit provision (through taxable years beginning on or before December 31, 2010).

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

2. Accelerated depreciation for business property on Indian reservations (sec. 142 of the bill and sec. 168(j) of the Code)

Present Law

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

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

"Qualified Indian reservation property" eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;[130] and (4) is not property placed in service for purposes of conducting gaming activities.[131] Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the

[130] For these purposes, related persons is defined in Sec. 465(b)(3)(C).

[131] Sec. 168(j)(4)(A).

reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).[132]

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

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2010.

Explanation of Provision

The provision extends for one year the present-law incentive relating to depreciation of qualified Indian reservation property (to apply to property placed in service through December 31, 2010).

Effective Date

The provision is effective for property placed in service after December 31, 2009.

3. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 143 of the bill and sec. 199 of the Code)

Present Law

In general

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning in 2009 the deduction is six percent, and after 2009, the deduction is nine percent of qualified production activities income. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

Qualified production activities income

In general, qualified production activities income is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that

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[132] Sec. 168(j)(4)(C).

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

<u>Domestic production gross receipts</u>

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[133] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film[134] produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

<u>Wage limitation</u>

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[135] Wages paid to bona fide residents of Puerto Rico generally are not included in the wage limitation amount.[136]

<u>Rules for Puerto Rico</u>

When used in the Code in a geographical sense, the term "United States" generally includes only the States and the District of Columbia.[137] A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's gross receipts are taxable under

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[133] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

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

[135] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. .

[136] Sec. 3401(a)(8)(C).

[137] Sec. 7701(a)(9).

the Federal income tax for individuals or corporations.[138] In computing the 50-percent wage limitation, that taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.[139]

The special rules for Puerto Rico apply only with respect to the first four taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2010.

Explanation of Provision

The provision allows the special domestic production activities rules for Puerto Rico to apply for the first five taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2011.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

4. Temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands (sec. 144 of the bill and sec. 7652(f) of the Code)

Present Law

A $13.50 per proof gallon[140] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[141] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[142]

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[143] The amount of the cover over is limited under Code section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon before January 1, 2010).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United

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[138] Sec. 199(d)(8)(A).

[139] Sec. 199(d)(8)(B).

[140] A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

[141] Sec. 5001(a)(1).

[142] Secs. 5062(b), 7653(b) and (c).

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

States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[144] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[145] All of the amounts covered over are subject to the limitation.

Explanation of Provision

The provision suspends for one year the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over limitation of $13.25 per proof gallon is extended for rum brought into the United States after December 31, 2009 and before January 1, 2011. After December 31, 2010, the cover over amount reverts to $10.50 per proof gallon.

Effective Date

The provision is effective for articles brought into the United States after December 31, 2009.

5. American Samoa economic development credit (sec. 145 of the bill and sec. 119 of Pub. L. No. 109-432)

Present and Prior Law

In general

For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit.[146] This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions. For purposes of the credit, possessions included, among other places, American Samoa. Subject to certain limitations described below, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment.[147] No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to

[144] Sec. 7652(e)(2).

[145] Secs. 7652(a)(3), (b)(3), and (e)(1).

[146] Secs. 27(b), 936.

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

taxable income that was taken into account in computing the credit under section 936.[148] The section 936 credit generally expired for taxable years beginning after December 31, 2005, but a special credit, described below, was allowed with respect to American Samoa.

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

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

Qualification as existing credit claimant

A corporation was an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit in an election in effect for its taxable year that included October 13, 1995.[149] A corporation that added a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

Economic activity-based limit

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

[148] Sec. 936(c).

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

Income-based limit

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

Repeal and phase out

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

American Samoa economic development credit

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006 is allowed a credit based on the economic activity-based limitation rules described above. The credit is not part of the Code but is computed based on the rules of sections 30A and 936. The credit is allowed for the first four taxable years of a corporation that begin after December 31, 2005, and before January 1, 2010.

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

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

The credit is not available for taxable years beginning after December 31, 2009.

Explanation of Provision

The provision allows the American Samoa economic development credit to apply for the first five taxable years of a corporation that begin after December 31, 2005, and before January 1, 2011.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

TITLE II − COMMUNITY ASSISTANCE PROVISIONS

1. Empowerment zone tax incentives (sec. 201 of the bill and secs. 1391 and 1202 of the Code)

Present Law

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 93") authorized the designation of nine empowerment zones ("Round I empowerment zones") to provide tax incentives for businesses to locate within certain targeted areas[150] designated by the Secretaries of the Department of Housing and Urban Development ("HUD") and the U.S Department of Agriculture ("USDA"). The Taxpayer Relief Act of 1997 authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones ("Round II empowerment zones"). The Community Renewal Tax Relief Act of 2000 ("2000 Community Renewal Act") authorized a total of ten new empowerment zones ("Round III empowerment zones"), bringing the total number of authorized empowerment zones to 40.[151] In addition, the 2000 Community Renewal Act conformed the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone incentives through December 31, 2009.[152]

The tax incentives available within the designated empowerment zones include a Federal income tax credit for employers who hire qualifying employees, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, deferral of capital gains tax on sale of qualified assets sold and replaced, and partial exclusion of capital gains tax on certain sales of qualified small business stock.

The following is a description of the tax incentives that are currently all scheduled to expire as of December 31, 2009.

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[150] The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

[151] The urban part of the program is administered by the HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA, Baltimore, MD, Chicago, IL, Cleveland, OH, Detroit, MI, Los Angeles, CA, New York, NY, and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY, Mid-Delta, MI, and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA, Cincinnati, OH, Columbia, SC, Columbus, OH, Cumberland County, NJ, El Paso, TX, Gary/Hammond/East Chicago, IN, and Ironton, OH/Huntington, WV. The five Round II rural empowerment zones are Desert Communities, CA, Griggs-Steele, ND, Oglala Sioux Tribe, SD, Southernmost Illinois Delta, IL, and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA, Jacksonville, FL, Oklahoma City, OK, Pulaski County, AR, San Antonio, TX, Syracuse, NY, Tucson, AZ, and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME, and Futuro, TX.

[152] If an empowerment zone designation were terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

Employment credit

A 20-percent wage credit is available to employers for the first $15,000 of qualified wages paid to each employee (i.e., a maximum credit of $3,000 with respect to each qualified employee) who (1) is a resident of the empowerment zone, and (2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.[153]

The wage credit rate applies to qualifying wages paid before January 1, 2010. Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business."[154]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[155] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[156] In addition, the $15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[157] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[158]

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional $35,000 of section 179 expensing (for a total of up to $285,000 in 2009) for qualified zone property placed in service before January 1, 2010.[159] The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the

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[153] Sec. 1396. The $15,000 limit is annual, not cumulative such that the limit is the first $15,000 of wages paid in a calendar year which ends with or within the taxable year.

[154] Secs. 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

[155] Sec. 280C(a).

[156] Secs. 1396(c)(3)(A) and 51A(d)(2).

[157] Secs. 1396(c)(3)(B) and 51A(d)(2).

[158] Sec. 38(c)(2).

[159] Secs. 1397A, 1397D.

year by the taxpayer exceeds $500,000.[160] The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. Special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.[161]

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.[162]

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any

[160] Sec. 1397A(a)(2), 179(b)(2), (7). For 2008 and 2009, the limit is $800,000.

[161] Sec. 1397C(b).

[162] Sec. 1397C(c).

business prohibited in connection with the employment credit.[163] In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

<u>Expanded tax-exempt financing for certain zone facilities</u>

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.[164] These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).[165]

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

The face amount of the bonds may not exceed $60 million for an empowerment zone in a rural area, $130 million for an empowerment zone in an urban area with zone population of less than 100,000, and $230 million for an empowerment zone in an urban area with zone population of at least 100,000.

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[163] Sec. 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. Sec. 144(c)(6).

[164] Sec. 1394.

[165] Sec. 1394(b)(3).

Elective roll over of capital gain from the sale or exchange of any qualified empowerment zone asset purchased after December 21, 2000

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset[166] held for more than one year and replaced within 60 days by another qualified empowerment zone asset in the same zone.[167] The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

Partial exclusion of capital gains on certain small business stock

For taxpayers other than corporations, 50 percent of the gain from the sale of qualified small business stock held for more than five years is excluded from gross income.[168] In the case of qualified small business stock acquired after December 21, 2000, in a corporation which is a qualified business entity (as defined in section 1397C(b)) during substantially all of the taxpayer's holding period, the exclusion is increased to 60 percent.[169] The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[170] A percentage of the excluded gain is an alternative minimum tax preference;[171] the portion of the gain includible in alternative minimum taxable income ("AMTI") is taxed at a maximum rate of 28 percent under the AMT.

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[166] The term "qualified empowerment zone asset" means any property which would be a qualified community asset (as defined in section 1400F, relating to certain tax benefits for renewal communities) if in section 1400F—(i) references to empowerment zones were substituted for references to renewal communities, (ii) references to enterprise zone businesses (as defined in section 1397C) were substituted for references to renewal community businesses, and (iii) the date of the enactment of this paragraph were substituted for "December 31, 2001" each place it appears. Sec. 1397B(b)(1)(A).

A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in an enterprise zone business), (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in an enterprise zone business), and (3) qualified community business property (meaning tangible property originally used in a enterprise zone business by the taxpayer) that is purchased or substantially improved after the date of the enactment of this paragraph.

For the definition of "enterprise zone business," see text accompanying *supra* notes 161-29. For the definition of "qualified business," see text accompanying *supra* note 163.

[167] Sec. 1397B.

[168] Sec. 1202.

[169] The increased exclusion does not apply to gain attributable to periods after December 31, 2014.

[170] Sec. 1(h).

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

The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

For all qualified small business stock acquired after February 17, 2009, and before January 1, 2011, the exclusion is increased to 75 percent. As a result of the increased exclusion, gain from the sale of qualified small business stock to which the provision applies is taxed at maximum effective rates of seven percent under the regular tax[172] and 12.88 percent under the AMT.[173]

Other tax incentives

Other incentives not specific to empowerment zones but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including empowerment zone residents (up to $2,400 per employee), and qualified zone academy bonds for certain public schools located in an empowerment zone, or expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced lunches.

Explanation of Provision

The provision extends for one year, through December 31, 2010, the period for which the designation of an empowerment zone is in effect, thus extending for one year the empowerment zone tax incentives, including the wage credit, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, and deferral of capital gains tax on sale of qualified assets sold and replaced.

The provision extends for one year, through December 31, 2015, the period for which gain from the sale or exchange of qualified business stock held for more than five years is excluded from gross income.

Effective Date

The provision relating to the designation of an empowerment zone and the provision relating to the exclusion of gain from the sale or exchange of qualified small business stock held for more than five years applies to periods after December 31, 2009.

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

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

2. Renewal community tax incentives (sec. 202 of the bill and secs. 1400E, 1400F, 1400I, and 1400J of the Code)

Present Law

The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, authorized the designation of 40 "renewal communities" within which special Federal tax incentives are available to attract business and investment to distressed urban and rural areas. The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

The Secretary of Housing and Urban Development has awarded renewal community designations to 40 selected communities (12 rural and 28 urban), including areas that remained distressed after previously having received empowerment zone or enterprise community designations.[174] To qualify as a renewal community, the community must have (1) a minimum unemployment rate of 9.45 percent (versus 6.3 percent for enterprise communities and empowerment zones) and (2) a minimum population of 4,000 within a metro area or 1,000 otherwise and a maximum population of 200,000. The designation of an area as a renewal community is effective on January 1, 2002, and terminates after December 31, 2009.[175]

The tax incentives provided under the renewal communities program include a Federal income tax credit for employers who hire qualifying employees, enhanced tax deductions on qualifying equipment and expenditures to construct or rehabilitate certain nonresidential buildings, and capital gains tax exclusion on sales of qualified assets. The tax incentives for renewal communities generally are available through December 31, 2009.[176]

The following is a description of these tax incentives.

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[174] The 28 urban renewal communities are: Mobile, AL; Los Angeles, San Diego, and San Francisco, CA; Atlanta, GA; Chicago, IL; New Orleans and Ouachita Parish, LA; Lawrence and Lowell, MA; Detroit and Flint, MI; Camden and Newark, NJ; Buffalo-Lackawanna, Niagara Falls, Rochester, and Schenectady, NY; Hamilton and Youngstown, OH; Philadelphia, PA; Charleston, SC; Chattanooga and Memphis, TN; Corpus Christi, TX; Tacoma and Yakima, WA; and Milwaukee, WI.

The 12 rural renewal communities are: Greene-Sumter, AL; Southern Alabama; Orange Cove and Parlier, CA; Eastern Kentucky; Central and Northern Louisiana; West-Central Mississippi; Turtle Mountain Band of Chippewa, ND; Jamestown, NY; El Paso County, TX; and Burlington, VT.

[175] The designation would terminate earlier than December 31, 2009, if (1) an earlier termination date is so designated by the State or local government, or (2) the Secretary of HUD revokes the designation as of an earlier date.

[176] If a renewal community designation is terminated prior to December 31, 2009, the tax incentives cease to be available as of the termination date.

Renewal community employment credit

A 15-percent wage credit is available to employers for the first $10,000 of qualified wages paid to each employee (i.e., a maximum credit of $1,500 with respect to each qualified employee) who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business of the employer.[177]

The wage credit applies to qualifying wages paid before January 1, 2010. Wages paid to a qualified employee who earns more than $10,000 are eligible for the wage credit (although only the first $10,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee, employed for at least 90 days, regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the renewal community may claim the wage credit, regardless of whether the employer meets the definition of a "renewal community business."[178]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[179] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[180] In addition, the $10,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[181] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[182]

Additional section 179 expensing

A renewal community business (as defined below in connection with the zero-percent capital gains rate) is allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service before January 1, 2010.[183] The section 179 expensing

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177 Sec. 1400H. This section treats a renewal community as an empowerment zone for purposes of section 1396 with respect to wages paid or incurred after December 31, 2001, subject to modifications of the applicable percentage amount (15 percent instead of 20 percent) and the qualified wage amount ($10,000 instead of $15,000).

178 Sec. 1400G. However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than 5 percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

179 Sec. 280C(a).

180 Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

181 Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

182 Sec. 38(c)(2).

183 Sec. 1400J.

allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $500,000.[184]

The term "qualified renewal property" is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the renewal community commences with the taxpayer, and (3) substantially all of the use of the property is in the renewal community in the active conduct of a trade or business by the taxpayer.[185] Special rules are provided in the case of property that is substantially renovated by the taxpayer.

Commercial revitalization deduction

Each State is permitted to allocate up to $12 million of commercial revitalization expenditures to each renewal community located within the State for each calendar year after 2001 and before 2010. The appropriate State agency will make the allocations pursuant to a qualified allocation plan.[186]

A commercial revitalization expenditure means the cost of a new building or the cost of substantially rehabilitating an existing building. The building must be used for commercial purposes and be located in a renewal community. In the case of the rehabilitation of an existing building, the cost of acquiring the building will be treated as a qualifying expenditure only to the extent that such costs do not exceed 30 percent of the other rehabilitation expenditures. The qualifying expenditures for any building cannot exceed $10 million.

A taxpayer can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service or (b) amortize all the expenditures ratably over the 120-month period beginning with the month the building is placed in service.[187] No depreciation is allowed for amounts deducted under this provision. The adjusted basis of the building is reduced by the amount of the commercial revitalization deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules.

The commercial revitalization deduction is treated in the same manner as the low-income housing credit in applying the passive loss rules. Thus, up to $25,000 of deductions (together with the other deductions and credits not subject to the passive loss limitation by reason of section 469(i)) are allowed to an individual taxpayer regardless of the taxpayer's adjusted gross income. The commercial revitalization deduction is allowed in computing a taxpayer's alternative minimum taxable income.

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[184] Sec. 1400J, 179(b)(2), 179(b)(7). For 2008 and 2009, the limit is $800,000.

[185] Secs. 1400J(b), 1397D.

[186] Sec. 1400I.

[187] Sec. 1400I.

Zero-percent capital gains rate

A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years.[188] A qualified community asset includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

A renewal community business is defined as a corporation or partnership (or proprietorship) if for the taxable year (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business[189] within a renewal community; (2) at least 50 percent of the total gross income is derived from the active conduct of a "qualified business" within a renewal community; (3) a substantial portion of the business's tangible property is used within a renewal community; (4) a substantial portion of the business's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a renewal community; (6) at least 35 percent of the employees are residents of the renewal community; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Property will continue to be a qualified community asset if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or tangible property used in) a renewal community business.

The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, is not eligible for the zero-percent rate.

Other tax incentives

Other incentives not specific to renewal communities but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including renewal community residents (up to $2,400 per employee), and

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[188] Sec. 1400F.

[189] A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, the leasing of real property that is located within the renewal community is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from renewal community businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of a renewal community.

qualified zone academy bonds for certain public schools expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced-cost lunches.

Explanation of Provision

The provision extends for one year, through December 31, 2010, the period for which the designation of a renewal community is in effect.

The provision extends for one year, through January 1, 2011, the period for which the taxpayer can acquire a qualified community asset defined to include qualified community stock, a qualified community partnership interest, and qualified community business property. The provision extends for one year, through December 31, 2015, the period for which qualified capital gain from the sale or exchange of a qualified community asset held for more than five years is excluded from gross income.

The provision extends for one year, through December 31, 2010, the period for which a taxpayer can place a qualified revitalization building in service for purposes of the commercial revitalization deduction.

The provision extends for one year, through December 31, 2010, the period through which the taxpayer can acquire qualified renewal property.

Effective Date

The provision relating to the designation of a renewal community and the provision relating to the exclusion of gain from the sale or exchange of a qualified community asset held for more than five years applies to periods after December 31, 2009. The provision relating to the period for which the taxpayer can acquire a qualified community asset or qualified renewal property applies to acquisitions after December 31, 2009. The provision relating to the placed in service date for qualified revitalization buildings eligible for the commercial revitalization deduction applies to buildings placed in service after December 31, 2009.

3. New markets tax credit (sec. 203 of the bill and sec. 45D of the Code)

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[190] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at

[190] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (December 21, 2000).

its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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

The Secretary has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[191] Under such Act, a targeted

[191] 12 U.S.C. 4702(17) (defines "low-income" for purposes of 12 U.S.C. 4702(20)).

population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

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

The maximum annual amount of qualified equity investments is capped at $5 billion per year for calendar years 2008 and 2009.

Explanation of Provision

The provision extends the new markets tax credit for one year, through 2010, permitting up to $5 billion in qualified equity investments for that calendar year. The provision also extends for one year, through 2015, the carryover period for unused new markets tax credits.

Effective Date

The provision applies to calendar years beginning after 2009.

4. Tax incentives for investment in the District of Columbia (sec. 204 of the bill and secs. 1400, 1400A, 1400B, and 1400C of the Code)

Present Law

In general

The Taxpayer Relief Act of 1997[192] designated certain economically depressed census tracts within the District of Columbia as the "District of Columbia Enterprise Zone," or "DC Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that comprise the District of Columbia Enterprise Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District of Columbia), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The District of Columbia Enterprise Zone designation remains in effect for the period from January 1, 1998, through December 31, 2009.

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

The following tax incentives are available for businesses located in an empowerment zone and the District of Columbia Enterprise Zone is treated as an empowerment zone for this purpose:[193] (1) 20-percent wage credit, (2) an additional $35,000 of section 179 expensing for qualified zone property, and (3) expanded tax-exempt financing for certain zone facilities. In addition, a zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years.

Present law also provides for a nonrefundable tax credit for first-time homebuyers of a principal residence in the District of Columbia.

Employment credit

A 20-percent wage credit is available to employers for the first $15,000 of qualified wages paid to each employee (i.e., a maximum credit of $3,000 with respect to each qualified employee) who (1) is a resident of the District of Columbia, and (2) performs substantially all employment services within an empowerment zone in a trade or business of the employer.[194]

The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business," as defined below.[195]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[196] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[197] In addition, the

[193] Sec. 1400(a)(2) ("except as otherwise provided in this subchapter, the District of Columbia Enterprise Zone shall be treated as an empowerment zone designated under subchapter U."). Herein all references to "empowerment zone" shall also include "the District of Columbia Enterprise Zone."

[194] Secs. 1396, 1400(d), and 1400(e).

[195] Secs. 1400(a)(2), 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business. Sec. 1396(d)(2).

[196] Sec. 280C(a).

[197] Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[198] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[199]

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional $35,000 of section 179 expensing (for a total of up to $285,000 in 2009) for qualified zone property placed in service after December 31, 2001, and before January 1, 2010.[200] The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $500,000.[201] The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. For this purpose, special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.[202]

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business

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[198] Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

[199] Sec. 38(c)(2).

[200] Sec. 1397D.

[201] Sec. 1397A(a)(2), 179(b)(2), (7). For 2008 and 2009, the limit is $800,000.

[202] Sec. 1397C(b).

(whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.[203]

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.[204] In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

Expanded tax-exempt financing for certain zone facilities

An enterprise zone business is permitted to borrow proceeds from the issuance of tax-exempt enterprise zone facility bonds (as defined in section 1394, without regard to the employee residency requirement) issued by the District of Columbia.[205] To qualify, 95 percent (or more) of the net proceeds must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property. Accordingly, most of the proceeds have to be used to finance certain facilities within the DC Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per enterprise zone business may not exceed $15 million and may be issued only while the DC Zone designation is in effect, from January 1, 1998 through December 31, 2009.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise

[203] Sec. 1397C(c).

[204] Sec. 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. Sec. 144(c)(6).

[205] Secs. 1394, 1400A.

zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).[206]

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

Zero-percent capital gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years.[207] In general, a "qualified DC Zone asset" means stock or partnership interests held in, or tangible property held by, a DC Zone business. For purposes of the zero-percent capital gains rate, the DC Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than ten percent.

In general, gain eligible for the zero-percent tax rate is that from the sale or exchange of a qualified DC Zone asset that is (1) a capital asset or (2) property used in a trade or business, as defined in section 1231(b). Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified DC Zone business.[208] However, no gain attributable to periods before January 1, 1998, and after December 31, 2014, is qualified capital gain.

District of Columbia homebuyer tax credit

First-time homebuyers of a principal residence in the District of Columbia[209] qualify for a tax credit of up to $5,000.[210] The $5,000 maximum credit amount applies both to individuals and married couples. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). The credit is available with respect to purchases of existing property as well as new construction.

A "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the

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[206] Sec. 1394(b)(3).

[207] Sec. 1400B.

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

[209] The homebuyer credit applies to the purchase of a principal residence anywhere in the District of Columbia. It is not limited to the D.C. Enterprise Zone area.

[210] Sec. 1400C.

District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies. A taxpayer will be treated as a first-time homebuyer with respect to only one residence--i.e., a taxpayer may claim the credit only once. A taxpayer's basis in a property is reduced by the amount of any homebuyer tax credit claimed with respect to such property.

The first-time homebuyer credit is a nonrefundable personal credit and may offset the regular tax and the alternative minimum tax. Any credit in excess of tax liability may be carried forward indefinitely. The homebuyer credit is generally available for property purchased after August 4, 1997, and before January 1, 2010. However, the credit does not apply to the purchase of a residence after December 31, 2008 to which the national first-time homebuyer credit under Section 36 of the Code applies.

Explanation of Provision

The provision extends for one year, through December 31, 2010, the designation of the District of Columbia Enterprise Zone.

The provision extends for one year the zero-percent capital gains rate applicable to capital gains from the sale or exchange of any DC Zone asset held for more than five years (and, as amended, acquired or substantially improved before January 1, 2011). The provision also extends for one year the period for which the term "qualified capital gain" refers. As amended, the term "qualified capital gain" shall not include any gain attributable to periods before January 1, 1998, or after December 31, 2015.

The provision extends the first-time homebuyer credit for one year (as amended, to apply to property purchased before January 1, 2011).

Effective Date

The provision extending the period of designation of the District of Columbia Enterprise Zone and the provision extending the period for which the term "qualified capital gain" refers applies to periods after December 31, 2009. The provision extending tax-exempt financing for certain zone facilities applies to bonds issued after December 31, 2009. The provision amending the definitions of DC Zone business stock, DC Zone partnership interest, and DC Zone business property applies to property acquired or substantially approved after December 31, 2009. The provision extending the first-time homebuyer credit applies to property purchased after December 31, 2009.

5. Special depreciation allowance for certain New York Liberty Zone property (sec. 205(a) of the bill and sec. 1400L(b) of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system ("MACRS").[211] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Present law includes an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified New York Liberty Zone ("Liberty Zone") property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.

For property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be eligible real property.[212] Second, substantially all of the use of such property must be in the Liberty Zone. Third, the original use[213] of the property in the Liberty Zone must commence with the taxpayer on or after September 11, 2001.[214] Finally, the property must be acquired by purchase[215] by the taxpayer on or after September 11, 2001.

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211 Sec. 168.

212 For property acquired and placed in service prior to December 31, 2006, Liberty Zone property included property to which the general rules of MACRS apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), or (3) computer software other than computer software covered by section 197. A special rule precluded the additional first-year depreciation under section 1400L(b) for (qualified New York Liberty Zone leasehold improvement property and (2) property eligible for the additional first-year depreciation under section 168(k) (i.e., property is eligible for only one 30 percent additional first year depreciation).

213 Thus, used property may constitute qualified property so long as it has not previously been used within the Liberty Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Liberty Zone began with the taxpayer would satisfy the "original use" requirement. See Treas. Reg. Sec. 1.48-2, Example 5.

214 A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

215 For this purpose, purchase is defined under section 179(d).

Nonresidential real property and residential rental property are eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed property, if as part of an integrated plan, such property replaces real property that is included in a continuous area that includes real property destroyed or condemned. It is intended that, for this purpose, real property destroyed (or condemned) only include circumstances in which an entire building or structure was destroyed (or condemned) as a result of the terrorist attacks. Otherwise, such property is considered damaged real property. For example, if certain structural components (e.g., wall, floors, or plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks, but the building is not destroyed (or condemned), then only costs related to replacing the damaged or destroyed components qualify for the provision.

Eligible real property that is constructed by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the construction of the property after September 11, 2001, and the property is placed in service on or before December 31, 2009 (assuming all other requirements are met). Property that is constructed for the taxpayer by another person under a contract that is entered into prior to the construction of the property is considered to be constructed by the taxpayer.[216]

The Liberty Zone means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

Explanation of Provision

The provision extends for one year the additional 30-percent depreciation deduction for eligible real property (to apply to property placed in service on or before December 31, 2010).

Effective Date

The provision is effective for eligible real property placed in service after December 31, 2009.

6. New York Liberty Zone bond provision (sec. 205(b) of the bill and sec. 1400L of the Code)

Present Law

An aggregate of $8 billion in tax-exempt private activity bonds is authorized for the purpose of financing the construction and repair of infrastructure in New York City ("Liberty Zone bonds"). The bonds must be issued before January 1, 2010.

[216] Similar rules applied with respect to the manufacture or production of tangible personal property for which the manufacture or production began after September 11, 2001, and that was placed in service on or before December 31, 2006.

Explanation of Provision

The provision extends authority to issue Liberty Zone bonds for one year (through December 31, 2010).

Effective Date

The provision is effective for bonds issued after December 31, 2009.

7. Work opportunity tax credit for Hurricane Katrina employees (sec. 206(a) of the bill)

Present Law

General work opportunity tax credit rules

Targeted groups eligible for the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups.

Qualified wages

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

Calculation of the credit

Generally, the credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages). In the case of certain qualified veterans, the definition of first-year wages is increased from $6,000 to $12,000, which increases the maximum credit per such employee to $4,800. Except for long-term family assistance recipients, no credit is allowed for second-year wages.

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

Minimum employment period

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

Certification requirement

In general, an individual is not treated as a member of a targeted group unless (1) on or before the day on which such individual begins work for the employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group or (2) on or before the day the individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual and not later than the twenty-first day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under the penalties of perjury, to the designated local agency as part of a written request for such a certification from such agency.

Qualifying rehires

No credit is available for any individual if, prior to the hiring date of such individual, such individual had been employed by the employer at any time.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration date

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before September 1, 2011.

Hurricane Katrina work opportunity tax credit rules

In general

A Hurricane Katrina employee is treated as a member of a targeted group for purposes of the work opportunity tax credit. A Hurricane Katrina employee is: (1) an individual who on August 28, 2005, had a principal place of abode in the core disaster area and is hired during the four-year period beginning on such date for a position, the principal place of employment of which is located in the core disaster area.

Certification requirement

The WOTC certification requirement is waived for such individuals. In lieu of the certification requirement, an individual may provide to the employer reasonable evidence that the individual is a Hurricane Katrina employee.

Qualifying rehires

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

Explanation of Provision

The provision extends the work opportunity tax credit for Hurricane Katrina employees for one year (through August 27, 2010).

Effective Date

The provision is effective for individuals hired after August 27, 2009 and before August 28, 2010.

8. Increased rehabilitation credit for structures in the Gulf Opportunity Zone (sec. 206(b) of the bill and sec. 1400N(h) of the Code)

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Present law increases from 20 to 26 percent, and from 10 to 13 percent, respectively, the credit under section 47 with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone, provided the qualified rehabilitation expenditures with respect to such buildings or structures are incurred on or after August 28, 2005, and before January 1, 2010. The provision is effective for expenditures incurred on or after August 28, 2005, for taxable years ending on or after August 28, 2005.

Explanation of Provision

The provision extends for one additional year the increase in the rehabilitation credit from 20 to 26 percent, and from 10 to 13 percent, respectively, with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone. Thus, the increase applies for qualified rehabilitation expenditures with respect to such buildings or structures incurred before January 1, 2011.

Effective Date

The provision is effective upon enactment.

9. Election for refundable low-income housing credit for 2010 (sec. 207 of the bill and sec. 42 of the Code)

Present Law

Tax credits

In general

The low-income housing credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels.[217] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

Volume limits

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. The aggregate credit authority provided annually to each State is indexed for inflation. For calendar year 2010 is $2.10 per resident, with a minimum annual cap of $2,430,000 for certain small population States.[218] These amounts are indexed for inflation. Projects that also receive financing with

[217] Sec. 42.

[218] Rev. Proc. 2009-50.

proceeds of tax-exempt bonds issued subject to the private activity bond volume limit do not require an allocation of the low-income housing credit.

Basic rule for Federal grants

The basis of a qualified building must be reduced by the amount of any federal grants with respect to such building.

Grants in lieu of tax credits for 2009

Low-income housing grant election amount

The Secretary makes a grant to the State housing credit agency of each State in an amount equal to the low-income housing grant election amount for 2009.

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

These grants are not taxable income to recipients.

Subawards to low-income housing credit buildings

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

Any building receiving grant money from a subaward is required to satisfy the low-income housing credit rules. The State housing credit agency shall perform asset management functions to ensure compliance with the low-income housing credit rules and the long-term viability of buildings financed with these subawards.[219] Failure to satisfy the low-income housing credit rules will result in recapture enforced by means of liens or other methods that the

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

Secretary (or delegate) deems appropriate. Any such recapture will be payable to the Secretary for deposit in the general fund of the Treasury.

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

Basic rule for Federal grants

The grants received under the grant election do not reduce tax basis of a qualified low-income building.

Reduction in low-income housing credit volume limit for 2009

The otherwise applicable low-income housing credit volume limit for any State for 2009 is reduced by the amount taken into account in determining the low-income housing grant election amount.

Appropriations

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

Explanation of Provision

The provision creates a refundable tax credit for 2010 (rather than to extend the 2009 election to substitute grants for nonrefundable tax credits). Specifically, the provision allows each State a refundable low income housing tax credit to finance low-income buildings through grants to taxpayers. The amount of such refundable credit for each State shall equal the low-income housing refundable tax credit election amount.

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

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

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

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

Effective Date

The provision is effective on the date of enactment.

TITLE III − DISASTER RELIEF PROVISIONS

1. Deductibility of personal casualty losses attributable to federally declared disasters (sec. 301 of the Act and sec. 165 of the Code)

<u>**Present Law**</u>

<u>Personal casualty losses</u>

<u>In general</u>

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[220] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of losses of property arising from fire, storm, shipwreck, or other casualty, or from theft.[221] In the case of any loss occurring in a disaster area and attributable to a federally declared disaster area, the taxpayer may elect to take into account the casualty loss for the taxable year immediately preceding the taxable year in which the disaster occurs.[222]

<u>Dollar limitation</u>

In the case of an individual, a casualty or theft loss not connected with a trade or business or transaction entered into for profit ("personal casualty loss") is allowed only to the extent the loss exceeds $500 ($100 for taxable years beginning after December 31, 2009).[223]

<u>Adjusted gross income limitation</u>

In general, the net aggregate personal casualty losses for a taxable year are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.[224]

Present law waives the 10-percent of adjusted gross income limitation for a "net disaster loss." The term "net disaster loss" means the excess of personal casualty losses attributable to a federally declared disaster occurring before January 1, 2010, and occurring in a disaster area, over personal casualty gains. The term "federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The term "disaster area" means the area so determined to warrant assistance.

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[220] Sec. 165(a).

[221] Sec. 165(c).

[222] Sec. 165(i).

[223] Sec. 165(h)(1).

[224] Sec. 165(h)(2).

Standard deduction

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions.[225] Unless an individual elects, no itemized deductions are allowed for the taxable year. The deduction for personal casualty losses is an itemized deduction.

Present law increases an individual taxpayer's standard deduction by the "disaster loss deduction." The "disaster loss deduction" means the net disaster loss (as defined above).

Explanation of Provision

One year extension of net disaster loss

The provision extends for one year the definition of a net disaster loss to include personal casualty losses attributable to federally declared disasters occurring in 2010. Thus the waiver of the 10-percent of adjusted gross income limitation for net disaster losses and the inclusion of net disaster losses in the standard deduction are extended for one year.

One year extension of the increase to $500 limitation per casualty

The provision extends the $500 per casualty dollar limitation for one year to taxable years beginning after December 31, 2009, and before January 1, 2011.

Effective Dates

The provision generally applies to disasters occurring after December 31, 2009.

The provision increasing the limitation per casualty to $500 applies to taxable years beginning after December 31, 2009.

2. Expensing of qualified disaster expenses (sec. 302 of the bill and sec. 198A of the Code)

Present Law

Under present law, a taxpayer may elect to treat any qualified disaster expense that is paid or incurred by the taxpayer as a deduction for the taxable year in which paid or incurred. For purposes of the provision, a qualified disaster expense is any otherwise capitalizable expenditure paid or incurred in connection with a trade or business or with business-related property that is: (1) for the abatement or control of hazardous substances that were released on account of a Federally declared disaster[226] occurring before January 1, 2010; (2) for the removal

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[225] Sec. 63.

[226] For these purposes, the term "Federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

of debris from, or the demolition of structures on, real property damaged or destroyed as a result of a Federally declared disaster occurring before January 1, 2010; or (3) for the repair of business-related property damaged as a result of a Federally declared disaster occurring before January 1, 2010. No inference is intended as to the proper present law treatment of expenditures to repair business-related property damaged in a casualty event. The purpose of the provision is to provide that, in any case in which such costs are otherwise required to be capitalized, the costs may be deducted in the taxable year paid or incurred to the extent incurred as a result of a Federally declared disaster.

For purposes of section 198A, "business-related property" is property held by the taxpayer for use in a trade or business, for the production of income, or as inventory. In addition, any deduction allowed under this provision is treated as a deduction for depreciation and section 1245 property for purposes of applying the depreciation recapture rules.

This provision does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

Explanation of Provision

The provision extends the deduction for qualified disaster expenditures for one year (to apply to amounts paid or incurred in connection with Federally declared disasters occurring before January 1, 2011).

Effective Date

The provision is effective for expenditures on account of disasters occurring after December 31, 2009.

3. Net operating losses attributable to federally declared disasters (sec. 303 of the bill and sec. 172 of the Code)

Present Law

Under present law, a net operating loss ("NOL") is, generally, the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.[227] NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[228]

[227] Sec. 172(b)(1)(A).

[228] Sec. 172(b)(2).

Section 172(b)(1)(J) provides a special five-year carryback period for NOLs to the extent of a qualified disaster loss. A qualified disaster loss is the lesser of: (1) the sum of (a) section 165 losses for the taxable year attributable to a Federally declared disaster[229] occurring after December 31, 2007, and before January 1, 2010, and occurring in a disaster area,[230] and (b) the deduction for the taxable year for qualified disaster expenses allowable under section 198A(a) or which would be allowable as a deduction under that section if not treated as an expense in another section of the Code; or (2) the NOL for the taxable year.

A qualified disaster loss does not include any loss with respect to any property used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property (as defined in section 1400N(p)(3)(B)).

The amount of the NOL to which the five-year carryback period applies is limited to the amount of the corporation's overall NOL for the taxable year. Any remaining portion of the taxpayer's NOL is subject to the general two-year carryback period. Ordering rules similar to those for specified liability losses apply to losses carried back under section 172(b)(1)(J).

Any taxpayer entitled to the five-year carryback under section 172(b)(1)(J) may elect to have the carryback period determined without regard to this provision. In addition, the general rule which limits a taxpayer's NOL deduction to 90 percent of alternative minimum taxable income ("AMTI") does not apply to any NOL to which the five-year carryback period applies under the provision. Instead, a taxpayer may apply such NOL carrybacks to offset up to 100 percent of AMTI.

Section 172(b)(1)(J) does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

Explanation of Provision

The provision extends the five-year NOL carryback period for one year (to apply to losses incurred in connection with Federally declared disasters occurring before January 1, 2011).

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[229] The term "federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

[230] The term "disaster area" means the area so determined to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Effective Date

The provision is effective for losses attributable to disasters occurring after December 31, 2009.

4. Special rules for mortgage revenue bonds in Federally declared disaster areas (sec. 304 of the bill and sec. 143 of the Code)

Present Law

Qualified mortgage bonds

Generally

Under present law, gross income does not include interest on State or local bonds.[231] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds that are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") (secs. 103(b)(1) and 141).

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, qualified home improvement, or rehabilitation of owner-occupied residences.

The Code imposes several limitations on qualified mortgage bonds in the case of a purchase of a residence, including purchase price limitations for the residence financed with bond proceeds and income limitations for homebuyers. In general, the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 90 percent of the average area purchase price (i.e., the average single-family residence purchase price purchased for the most recent one-year period in the statistical area in which the residence is located) (sec. 143(e)). The income limitation generally is met if all the owner-financing provided under the issue is provided to individuals who have family income of 115 percent or less of the applicable median family income (sec. 143(f)).

Qualified home improvement loans are defined as financing, not in excess of $15,000, of alterations, repairs, and improvements on or in connection with an existing residence by an owner thereof. These are further limited only to such items as substantially protect or improve the basic livability or energy efficiency of the property.

Rehabilitation loans are eligible for such financing if: (1) the mortgagor receiving the financing is the first resident after the completion of the rehabilitation; (2) at least 20 years have

[231] Sec. 103

elapsed between the first use of the residence and the start of the physical work of the rehabilitation; (3) certain percentages of internal and external walls are retained after the rehabilitation; and (4) rehabilitation expenditures equal at least 25 percent of the taxpayer's adjusted basis in the residence after such rehabilitation (sec. 143 (k)(5)).

First-time homebuyers

In addition to the purchase price and income limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement) (sec. 143(d)). The first-time homebuyer requirement does not apply to targeted area residences (described below).

Special rules for targeted area residences

A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress (sec. 143(j)).

In addition to the waiver of the first-time homebuyer rule, targeted area residences have special purchase price limitations and income limitations. For targeted area residences, the purchase price limitation is applied by substituting 110 percent for 90 percent (i.e., the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 110 percent of the average area purchase applicable to the residence) (sec. 143(e)(5)). For targeted area residences, the income limitation generally is met if at least two-thirds of all the owner-financing provided under the issue is provided to individuals who have family income of 140 percent or less of the applicable median family income. The other third is not subject to an income limitation (sec. 143(f)(3)).

Special rules for Federally declared disaster areas

A temporary provision waives the first-time homebuyer requirement for residences located in Federally declared disaster areas (sec. 143(k)(11)). Also, under the provision, residences located in Federally declared disaster areas are treated as targeted area residences for purposes of the income and purchase price limitations. The special rules for residences located in Federally declared disaster areas applies to bonds issued after May 1, 2008, and before January 1, 2010.

Election to waive certain mortgage revenue bond rules

In general

Present law allows certain taxpayers affected by natural disasters to elect to waive the first-time homebuyer requirement and modify the purchase price limitation from 90% to 110%, if taxpayer's principal residence is destroyed as a result of a Federally declared disaster. Any owner-financing provided with respect to repair or reconstruction is deemed a qualified rehabilitation loan, if the taxpayer's principal residence is damaged as a result of a Federally declared disaster. If a taxpayer makes such an election, then the otherwise applicable special rules for Federally declared disaster areas do not apply. If there is no such election, then the otherwise applicable special rules for Federally declared disaster areas apply.

Principal residence destroyed

This election for destroyed residences is available for principal residences located in Federally declared disaster areas when the principal residence of a taxpayer is: (1) rendered unsafe for use by reason of a Federally declared disaster occurring before January 1, 2010; or (2) demolished or relocated by reason of an order of the government of a State or political subdivision thereof on account of a Federally declared disaster occurring before January 1, 2010. This election applies for the two-year period beginning on the date of the disaster.

The election provides for: (1) a waiver of the first-time homebuyer requirement; and (2) the purchase price limitation otherwise applicable to targeted area residences (i.e., the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 110 percent of the average area purchase applicable to the residence).

Principal residence damaged

The election for damaged residences allows certain taxpayers to elect to waive the otherwise applicable qualified rehabilitation loan rules and treat the cost of repair or reconstruction of a taxpayer's principal residence as a qualified rehabilitation loan. This election is limited to taxpayers whose principal residence is damaged as a result of a Federally declared disaster occurring before January 1, 2010. Such rehabilitation loans are limited to the lesser of $150,000 or the cost of repair or reconstruction.

Other rules

Once made, an election under these provisions may not be revoked by the taxpayer except with the consent of the Secretary.

For purposes of the provision, the term "Federally declared disaster" has the same definition as in section 165(h)(3)(C)(i) of the Code.[232] The provision is effective for disaster occurring after December 31, 2007. However, the provision does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.[233]

[232] Sec. 165 relates to personal casualty losses.

[233] Sec. 712 of Pub. L. No. 110-343 Div. C.

Explanation of Provision

The provision extends: (1) the special rules for Federally declared disaster areas; and (2) the election to waive certain mortgage revenue bond rules relating to Federally declared disasters for one additional year (through 2010).

Effective Date

The provision relating to the special rules for Federally declared disaster areas is effective for bonds issued after December 31, 2009. The provision relating to the election to waive certain mortgage revenue bond rules relating to Federally declared disasters is effective for disasters occurring after December 31, 2009.

5. Special depreciation allowance and expensing for qualified disaster assistance property (sec. 305 of the bill and secs. 168(n) and 179(e) of the Code)

Present Law

Special depreciation allowance

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system ("MACRS").[234] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Present law includes an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of any "qualified disaster assistance property."[235] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies.

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[234] Sec. 168.

[235] Sec. 168(n).

Qualified disaster assistance property means any property: (1) to which the general rules of the MACRS apply with (a) an applicable recovery period of 20 years or less, (b) computer software other than computer software covered by section 197, (c) water utility property (as defined in section 168(e)(5)), (d) certain leasehold improvement property, or (e) certain nonresidential real property and residential rental property; (2) substantially all of which is used in a disaster area with respect to a Federally declared disaster occurring before January 1, 2010, in the active conduct of a trade or business by the taxpayer in such disaster area; (3) which rehabilitates property damaged, or replaces property destroyed or condemned, as a result of the Federally declared disaster, except that property is treated as replacing property destroyed or condemned if, as part of an integrated plan, the property replaces property which is included in a continuous area which includes real property destroyed or condemned, and is similar in nature to, and located in the same county as, the property being rehabilitated or replaced; (4) the original use of the property in the disaster area commences with an eligible taxpayer (a taxpayer who has suffered an economic loss attributable to a Federally declared disaster) on or after the applicable disaster date (the date on which a Federally declared disaster occurs); (5) which is acquired by an eligible taxpayer by purchase (as defined under section 179(d)) by the taxpayer on or after the applicable disaster date (and no written binding contract for the acquisition was in effect before such date); and (6) which is placed in service by an eligible taxpayer on or before the date which is the last day of the third calendar year following the applicable disaster date (the fourth calendar year in the case of nonresidential real property and residential rental property).[236]

Qualified disaster assistance property does not include any property: (1) to which the special allowance for depreciation under section 168(k) (regardless of any election under section 168(k)(4)), section 168(l) for cellulosic biofuel property, or section 168(m) for reuse and recycling property applies; (2) to which the special allowance for qualified Gulf Opportunity Zone property under section 1400N(d) applies; (3) used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property (as defined in section 1400N(p)(3)(B)); (4) to which the alternative depreciation system under section 168(g) applies (determined without regard to the election to use such system under section 168(g)(7)); (5) any portion of which is financed with proceeds of any obligation the interest on which is exempt from tax under section 103; and (6) which is a qualified revitalization building with respect to which the taxpayer has made an election under section 1400I(a) to either expense one-half of qualified revitalization expenditures or recover such expenditures over 120 months.[237] A taxpayer may elect to not apply the rules of this provision with respect to any class of property for any taxable year.

The special rules of section 168(k)(2)(E) apply with modifications. For example, property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after the applicable disaster date, and which is placed in service by an eligible taxpayer on or before the date which is the last day of the third calendar year following the applicable disaster date (the

[236] Sec. 168(n)(2)(A).

[237] Sec. 168(n)(2)(B).

fourth calendar year in the case of nonresidential real property and residential rental property). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Recapture rules similar to section 179(d)(10) apply to any qualified disaster assistance property that ceases to be qualified disaster assistance property.

Section 179 expensing

A taxpayer that satisfies limitations on annual investment may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[238] For taxable years beginning in 2009, the maximum amount that a taxpayer may expense is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000.[239] For taxable years beginning in 2010, the maximum amount that a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation.

Qualified disaster assistance property is eligible for increased dollar limits on expensing under section 179. Specifically, the maximum amount that a taxpayer may expense is increased by the lesser of $100,000 or the cost of qualified section 179 disaster assistance property placed in service in the taxable year. The $800,000 limitation (for taxable years beginning in 2009) is increased by the lesser of $600,000 or the cost of qualified section 179 disaster assistance property placed in service during the taxable year.[240]

Qualified section 179 disaster assistance property is depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software) that meets the definition of qualified disaster assistance property.[241] Thus, the provision applies with respect to property placed in service in a disaster area with respect to a Federally declared disaster occurring before January 1, 2010.

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

[239] The temporary $250,000 and $800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, and extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

[240] Sec. 179(e)(1).

[241] Sec. 179(e)(2).

Explanation of Provision

The provision extends for one year the special depreciation allowance and expensing provisions for qualified disaster assistance property (to apply to property placed in service in a disaster area with respect to a Federally declared disaster occurring before January 1, 2011).

Effective Date

The provision is effective for disasters occurring after December 31, 2009.

TITLE IV − ENERGY PROVISIONS

1. Incentives for biodiesel and renewable diesel (sec. 401 of the bill and sec. 40A of the Code)

Present Law

Biodiesel

The Code provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").[242] The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2009.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the EPA under section 211 of the Clean Air Act (42 U.S.C. sec. 7545) and (2) the requirements of the American Society of Testing and Materials ("ASTM") D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, camelina, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

Biodiesel mixture credit

The biodiesel mixture credit is $1.00 for each gallon of biodiesel (including agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

[242] Sec. 40A.

Per IRS guidance a mixture need only contain 1/10th of one percent of diesel fuel to be a qualified mixture.[243] Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

<u>Biodiesel credit (straight biodiesel)</u>

The biodiesel credit is $1.00 for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle.

<u>Small agri-biodiesel producer credit</u>

The Code provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel fuel mixture credits. The credit is a 10-cents-per-gallon credit for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

<u>Biodiesel mixture excise tax credit</u>

The Code also provides an excise tax credit for biodiesel mixtures.[244] The credit is $1.00 for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[245]

The credit is not available for any sale or use for any period after December 31, 2009. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

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[243] Notice 2005-62, I.R.B. 2005-35, 443 (2005). "A biodiesel mixture is a mixture of biodiesel and diesel fuel containing at least 0.1 percent (by volume) of diesel fuel. Thus, for example, a mixture of 999 gallons of biodiesel and 1 gallon of diesel fuel is a biodiesel mixture." Id.

[244] Sec. 6426(c).

[245] Sec. 6426(c)(4).

Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.[246] The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels. To the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, if the person has no section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2009.

Renewable diesel

"Renewable diesel" is liquid fuel that (1) is derived from biomass (as defined in section 45K(c)(3)), (2) meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act, and (3) meets the requirements of the ASTM D975 or D396, or equivalent standard established by the Secretary. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces. Renewable diesel also includes fuel derived from biomass that meets the requirements of a Department of Defense specification for military jet fuel or an ASTM for aviation turbine fuel.

For purposes of the Code, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[247] The incentive for renewable diesel is $1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2009.

Explanation of Provision

The provision extends the income tax, excise tax and payment provisions for biodiesel and renewable diesel for one additional year (through December 31, 2010).

Effective Date

The provision is effective for sales and uses after December 31, 2009.

[246] Sec. 6427(e).

[247] Secs. 40A(f), 6426(c), and 6427(e).

2. Alternative motor vehicle credit for heavy hybrids (sec. 402 of the bill and sec. 30B of the Code)

Present Law

In general

A credit is available for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the taxable year.[248] In general, the credit amount varies depending upon the type of technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005. The credit terminates after 2009, 2010, or 2014, depending on the type of vehicle.

In general, the credit is allowed to the vehicle owner, including the lessor of a vehicle subject to a lease. If the use of the vehicle is described in paragraphs (3) or (4) of section 50(b) (relating to use by tax-exempt organizations, governments, and foreign persons) and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit. The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as a portion of the general business credit.

Hybrid vehicles

Qualified hybrid vehicles

A qualified hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy that include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). A qualified hybrid vehicle must be placed in service before January 1, 2011 (January 1, 2010 in the case of a hybrid vehicle weighing more than 8,500 pounds).

Hybrid vehicles that are automobiles and light trucks

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard (the "base fuel economy") and (2) a conservation credit based on the estimated lifetime fuel savings of the qualified vehicle compared to a comparable 2002 model year vehicle that is powered solely by a gasoline or diesel internal combustion engine. A

[248] Sec. 30B.

qualified hybrid automobile or light truck must have a maximum available power[249] from the rechargeable energy storage system of at least four percent. In addition, the vehicle must meet or exceed certain Environmental Protection Agency ("EPA") emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less, the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards.

Table 2, below, shows the fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of the base fuel economy.

Table 2.–Fuel Economy Credit

Credit	If Fuel Economy of the Hybrid Vehicle Is: at least	but less than
$400	125% of base fuel economy	150% of base fuel economy
$800	150% of base fuel economy	175% of base fuel economy
$1,200	175% of base fuel economy	200% of base fuel economy
$1,600	200% of base fuel economy	225% of base fuel economy
$2,000	225% of base fuel economy	250% of base fuel economy
$2,400	250% of base fuel economy	

Table 3, below, shows the conservation credit.

Table 3.–Conservation Credit

Estimated Lifetime Fuel Savings (gallons of gasoline)	Conservation Amount
At least 1,200 but less than 1,800	$250
At least 1,800 but less than 2,400	$500
At least 2,400 but less than 3,000	$750
At least 3,000	$1,000

[249] For hybrid passenger vehicles and light trucks, the term "maximum available power" means the maximum power available from the rechargeable energy storage system, during a standard 10 second pulse power or equivalent test, divided by such maximum power and the SAE net power of the heat engine. Sec. 30B(d)(3)(C)(i).

Limitation on number of qualified hybrid and advanced lean burn technology vehicles eligible for the credit

There is a limitation on the number of passenger and light truck qualified hybrid vehicles and advanced lean burn technology vehicles[250] sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th hybrid and advanced lean burn technology vehicle sale occurring after December 31, 2005. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

Thus, for example, summing the sales of qualified hybrid vehicles that are passenger vehicles or light trucks and all sales of qualified advanced lean burn technology vehicles, if a manufacturer records the sale of its 60,000th qualified vehicle in February of 2007, taxpayers purchasing such vehicles from the manufacturer may claim the full amount of the credit on their purchases of qualified vehicles through June 30, 2007. For the period July 1, 2007, through December 31, 2007, taxpayers may claim one half of the otherwise allowable credit on purchases of qualified vehicles of the manufacturer. For the period January 1, 2008, through June 30, 2008, taxpayers may claim one quarter of the otherwise allowable credit on the purchases of qualified vehicles of the manufacturer. After June 30, 2008, no credit may be claimed for purchases of such hybrid vehicles or advanced lean burn technology vehicles sold by the manufacturer.

Hybrid vehicles that are medium and heavy trucks

In the case of a qualified hybrid vehicle weighing more than 8,500 pounds, the amount of credit is determined by the estimated increase in fuel economy and the incremental cost of the hybrid vehicle compared to a comparable vehicle powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size, and use of the vehicle. For a vehicle that achieves a fuel economy increase of at least 30 percent but less than 40 percent, the credit is equal to 20 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of at least 40 percent but less than 50 percent, the credit is equal to 30 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy

[250] A qualified advanced lean burn technology vehicle is a passenger automobile or a light truck that incorporates direct injection, achieves at least 125 percent of the 2002 model year city fuel economy, and for 2004 and later model vehicles meets or exceeds certain Environmental Protection Agency emissions standards. Sec. 30B(c)(3). For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards. *Ibid.* A qualified advanced lean burn technology vehicle must be placed in service before January 1, 2011. Sec. 30B(k)(2).

increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

The credit is subject to certain maximum applicable incremental cost amounts. For a qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds, the maximum allowable incremental cost amount is $7,500. For a qualified hybrid vehicle weighing more than 14,000 pounds but not more than 26,000 pounds, the maximum allowable incremental cost amount is $15,000. For a qualified hybrid vehicle weighing more than 26,000 pounds, the maximum allowable incremental cost amount is $30,000.

A qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualified hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.[251]

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy by vehicle type and vehicle inertia weight class. For this purpose, "vehicle inertia weight class" has the same meaning as when defined in regulations prescribed by the EPA for purposes of Title II of the Clean Air Act. Table 4, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

[251] In the case of such heavy-duty hybrid motor vehicles, the percentage of maximum available power is computed by dividing the maximum power available from the rechargeable energy storage system during a standard 10-second pulse power test, divided by the vehicle's total traction power. A vehicle's total traction power is the sum of the peak power from the rechargeable energy storage system and the heat (e.g., internal combustion or diesel) engine's peak power. If the rechargeable energy storage system is the sole means by which the vehicle can be driven, then the total traction power is the peak power of the rechargeable energy storage system.

Table 4.–2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9
3,500	22.6	21.8
4,000	19.8	19.4
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Explanation of Provision

The provision extends for one year the credit available to hybrid vehicles that are medium and heavy trucks.

Effective Date

The provision is effective for property purchased after December 31, 2009.

3. Alternative fuel credits for natural gas and liquefied petroleum gas (sec. 403 of the bill and secs. 6426 and 6427(e) of the Code)

Present Law

The Code provides two per-gallon excise tax credits with respect to alternative fuel, the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process ("coal-to-liquids"), compressed or liquified gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after September 30, 2009 through December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 50 percent of such facility's total carbon dioxide emissions. The sequestration percentage increases to 75 percent for fuel produced after December 30, 2009.

The alternative fuel credit is allowed against section 4041 liability, and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents[252] of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An "alternative fuel mixture" is a mixture of alternative fuel and taxable fuel that contains at least 1/10 of one percent taxable fuel. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits generally expire after December 31, 2009 (September 30, 2014 for liquefied hydrogen).

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expire after December 31, 2009. With respect to liquefied hydrogen, the payment provisions expire after September 30, 2014. The alternative fuel credit and alternative fuel mixture credit must first be applied to excise tax liability for special and alternative fuels, and any excess credit may be taken as a payment.

[252] "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

Explanation of Provision

The provision extends the alternative fuel credit and payment provisions for compressed and liquefied natural gas, and liquefied petroleum gas (other than liquefied petroleum gas for use in forklifts) for one additional year (through December 31, 2010).

Effective Date

The provision is effective for fuel sold or used after December 31, 2009.

4. Special rule to implement FERC and State electric restructuring policy (sec. 404 of the bill and sec. 451(i) of the Code)

Present Law

A taxpayer selling property generally recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[253] (the "reinvestment property").[254] If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by a qualified electric utility to an independent transmission company prior to January 1, 2010. A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both (1) a transmitting utility (as defined in the Federal Power Act)[255] with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act).[256]

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[253] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

[254] Sec. 451(i).

[255] Sec. 3(23), 16 U.S.C. 796, defines "transmitting utility" as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or Federal power marketing agency which owns or operates electric power transmission facilities which are used for the sale of electric energy at wholesale.

[256] Sec. 3(22), 16 U.S.C. 796, defines "electric utility" as any person or State agency (including any municipality) which sells electric energy; such term includes the Tennessee Valley Authority, but does not include any Federal power marketing agency.

In general, an independent transmission company is defined as: (1) an independent transmission provider[257] approved by the Federal Energy Regulatory Commission ("FERC"); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider no later than four years after the close of the taxable year in which the transaction occurs; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1). Exempt utility property does not include any property that is located outside of the United States.

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

Explanation of Provision

The provision extends the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility prior to January 1, 2011.

Effective Date

The extension provision applies to dispositions after December 31, 2009.

[257] For example, a regional transmission organization, an independent system operator, or an independent transmission company.

TITLE V − FOREIGN ACCOUNT TAX COMPLIANCE

A. Increase Disclosure of Beneficial Owners

1. Reporting on certain foreign accounts (sec. 501 of the bill and new secs. 1471, 1472, 1473, and 1474 of the Code, and sec. 6611 of the Code)

Present Law

Withholding on payments to foreign persons

Payments of U.S.-source fixed or determinable annual or periodical ("FDAP") income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[258] The term "FDAP income" includes all items of gross income, except gains on sales of property (including market discount on bonds and option premiums) and insurance premiums paid to a foreign insurer or reinsurer.[259]

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[260] Dividend income is sourced by reference to the payor's place of incorporation.[261] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Rental income is sourced by reference to the location or place of use of the leased property.[262] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property

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[258] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b). Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"). For purposes of the withholding tax rules applicable to payments to nonresident alien individuals and foreign corporations, a withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[259] Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2); Rev. Rul. 2004-75, 2004-2 C.B. 109 (holding that the income of a nonresident alien individual under a life insurance or annuity contract issued by a foreign branch of a U.S. life insurance company is FDAP income from U.S. sources); Rev. Rul. 2004-97, 2004-2 C.B. 516 (stating that Rev. Rul. 2004-75 does not apply to payments made before January 1, 2005, pursuant to binding life insurance or annuity contracts issued by a foreign branch on or before July 12, 2004). However, gain on a sale or exchange of section 306 stock of a domestic corporation is FDAP income to the extent section 306(a) treats the gain as ordinary income. Treas. Reg. sec. 1.306-3(h).

[260] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1). Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source interest under section 884(f)(1).

[261] Secs. 861(a)(2), 862(a)(2).

[262] Sec. 861(a)(4).

located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible. Royalties are sourced in the place of use (or the privilege of use) of the property for which the royalties are paid.[263] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, portfolio interest, and capital gains. Since 1984, the United States has not imposed withholding tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States.[264] Portfolio interest includes, generally, any interest (including original issue discount) other than interest received by a 10-percent shareholder,[265] certain contingent interest,[266] interest received by a controlled foreign corporation from a related person,[267] and interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[268]

In the case of interest paid on a debt obligation that is in registered form,[269] the portfolio interest exemption is available only to the extent that the U.S. person otherwise required to

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[263] *Ibid.*

[264] Secs. 871(h), 881(c). Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of domestic corporations to raise capital in the Eurobond market (i.e., the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the Treasury Department direct access to the Eurobond market. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

[265] Sec. 871(h)(3). A 10-percent shareholder includes any person who owns 10 percent or more of the total combined voting power of all classes of stock of the corporation (in the case of a corporate obligor), or 10 percent or more of the capital or profits interest of the partnership (in the case of a partnership obligor). The attribution rules of section 318 apply for this purpose, with certain modifications.

[266] Sec. 871(h)(4). Contingent interest generally includes any interest if the amount of such interest is determined by reference to any receipts, sales, or other cash flow of the debtor or a related person; any income or profits of the debtor or a related person; any change in value of any property of the debtor or a related person; any dividend, partnership distributions, or similar payments made by the debtor or a related person; and any other type of contingent interest identified by Treasury regulation. Certain exceptions also apply.

[267] Sec. 881(c)(3)(C). A related person includes, among other things, an individual owning more than 50 percent of the stock of the corporation by value, a corporation that is a member of the same controlled group (defined using a 50-percent common ownership test), a partnership if the same persons own more than 50 percent in value of the stock of the corporation and more than 50 percent of the capital interests in the partnership, any U.S. shareholder (as defined in section 951(b) and generally including any U.S. person who owns 10 percent or more of the voting stock of the corporation), and certain persons related to such a U.S. shareholder.

[268] Sec. 881(c)(3)(A).

[269] An obligation is treated as in registered form if (1) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new

withhold tax (the "withholding agent") has received a statement made by the beneficial owner of the obligation (or a securities clearing organization, bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business) that the beneficial owner is not a U.S. person.[270]

Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[271] In addition, interest on bank deposits, deposits with domestic savings and loan associations, and certain amounts held by insurance companies are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[272] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.[273] Consequently, there is no information reporting with respect to payments of such amounts.[274]

Gains derived from the sale of property by a nonresident alien individual or foreign corporation generally are exempt from U.S. tax, unless they are or are treated as effectively connected with the conduct of a U.S. trade or business. Gains derived by a nonresident alien individual generally are subject to U.S. taxation only if the individual is present in the United States for 183 days or more during the taxable year.[275] Foreign corporations are subject to tax

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instrument to the new holder, (2) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent, or (3) the obligation is registered as to both principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Treas. Reg. sec. 5f.103-1(c).

[270] Sec. 871(h)(2)(B), (5). This certification of non-U.S. ownership most commonly is made on an IRS Form W-8. This certification is not valid if the Secretary determines that statements from the person making the certification do not meet certain requirements.

[271] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[272] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii). If the bank deposit interest is effectively connected with a U.S. trade or business, it is subject to regular U.S. income tax rather than withholding tax.

[273] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[274] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). However, Treasury regulations require a bank to report interest if the recipient is a resident of Canada and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5), 1.6049-8. This reporting is required to comply with the obligations of the United States under the U.S.-Canada income tax treaty. T.D. 8664, 1996-1 C.B. 292. In 2001, the IRS and the Treasury Department issued proposed regulations that would require annual reporting to the IRS of U.S. bank deposit interest paid to any foreign individual. 66 Fed. Reg. 3925 (Jan. 17, 2001). The 2001 proposed regulations were withdrawn in 2002 and replaced with proposed regulations that would require reporting with respect to payments made only to residents of certain specified countries (Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and the United Kingdom). 67 Fed. Reg. 50,386 (Aug. 2, 2002). The proposed regulations have not been finalized.

[275] Sec. 871(a)(2). In most cases, however, an individual satisfying this presence test will be treated as a U.S. resident under section 7701(b)(3), and thus will be subject to full residence-based U.S. income taxation.

with respect to certain gains on disposal of timber, coal, or domestic iron ore and certain gains from contingent payments made in connection with sales or exchanges of patents, copyrights, goodwill, trademarks, and similar intangible property.[276] Gain from the disposition of certain U.S. real property interests (which include interests in U.S. real property holding corporations) are treated as effectively connected with a U.S. trade or business.[277] Special rules apply in the case of interests in real estate investment trusts or regulated investment companies that may hold, or interests in which may be treated, as U.S. real property interests.[278] Most capital gains realized by foreign investors on the sale of portfolio investment securities thus are exempt from U.S. taxation.

The 30-percent withholding tax may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident. Thus, most U.S. income tax treaties provide a zero rate of withholding tax on interest payments (other than certain interest the amount of which is determined by reference to certain income items or other amounts of the debtor or a related person). Most U.S. income tax treaties also reduce the rate of withholding on dividends to 15 percent (in the case of portfolio dividends) and to five percent (in the case of "direct investment" dividends paid to a 10 percent-or-greater shareholder).[279] For royalties, the U.S. withholding rate is typically reduced to five percent or to zero. In each case, the reduced withholding rate is available only to a beneficial owner who qualifies as a resident of the treaty country within the meaning of the treaty and otherwise satisfies any applicable limitation on benefits provisions of the treaty.

Refund or credits of taxes withheld from foreign persons

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report those payments, including any amounts of U.S. tax withheld, to the IRS on IRS Forms 1042 and 1042-S by March 15 of the calendar year following the year in which the payment is made.[280] To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.[281] If the agent withholds more than is

[276] Secs. 881(a), 631(b), and 631(c).

[277] Sec. 897. Section 1445 imposes withholding requirements with respect to such dispositions.

[278] See Sec. 897(h).

[279] A number of recent U.S. income tax treaties eliminate withholding tax on dividends paid to a majority (typically 80-percent or greater) shareholder, including the present treaties with Australia, Belgium, Denmark, Finland, Germany, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom.

[280] Treas. Reg. sec. 1.1461-1(b), (c). IRS Form 1042, "Annual Withholding Tax Return for U.S.-Source Income of Foreign Persons," is the IRS form on which a withholding agent reports a summary of the total U.S. source income paid and withholding tax withheld on foreign persons for the year. IRS Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," is the IRS form on which a withholding agent reports, to the foreign person and the IRS, a foreign person's U.S.-source income that is subject to reporting.

[281] Sec. 1462.

required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

Payment of tax

The date an amount is paid is relevant for determining the limitations period in which to claim a refund, the amount of refund available,[282] and the period for which interest may accrue on any overpayment.[283] An amount that is withheld, paid or credited as an estimate or deposit of tax generally does not count as the payment of tax until applied to a specific tax liability. To the extent that amounts previously withheld, paid or credited as an estimate or deposit of tax are applied to the tax liability for a year, they are deemed to have been paid as of the last day prescribed for payment of the tax, for both the recipient of the income[284] and the withholding agent.[285] Amounts that are refunded, credited to other periods, or offset against other liabilities are not considered as paid for this purpose.[286] Any amount that was previously paid but has been credited to a later year is considered credited on the last day prescribed for the payment of tax.[287]

Interest on overpayments

The IRS is generally required to pay interest to a taxpayer whenever there is an overpayment of tax.[288] An overpayment of tax exists whenever more than the correct amount of tax is paid as of the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.[289] However, no interest is required to be paid by the IRS if it refunds or credits the amount due with 45 days of the filing of the return.[290] Notwithstanding these general rules, if a required return on which the payment should have been reported is either not filed, or is filed late, no interest on the overpayment accrues for any period prior to the filing of the return.[291]

[282] See secs. 6511(a) (prescribing the period within which a claim must be filed) and 6511(b)(2) (limiting the amount that can be recovered if a claim is not filed within three years of filing a return). If a return is not filed, a claim for refund of any tax paid must be filed within two years of payment.

[283] Secs. 6611(b)(2) and 6611(d).

[284] Sec. 6513(b)(3).

[285] Sec. 6513(c)(2).

[286] Sec. 6513(d).

[287] Sec. 6513(d).

[288] Sec. 6611.

[289] Sec. 6601(b).

[290] Sec. 6611(e).

[291] Sec. 6611(b)(3).

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on both underpayments and overpayments is compounded daily.[292] A special net interest rate of zero applies in situations where interest is both payable and allowable on offsetting amounts of overpayment and underpayment.[293] For individuals, interest on both underpayments and overpayments accrues at a rate equal to the short term applicable Federal rate (AFR) plus three percentage points.[294] Interest on corporate overpayments generally accrues at a rate equal to the short term AFR plus two percentage points, unless the overpayment exceeds $10,000 in which case interest accrues at a rate equal to the short term AFR plus one-half percentage point.

Period of overpayment

If the overpayment is to be refunded to the taxpayer, interest accrues on the overpayment from the later of the due date of the return or the date the payment is made until a date that is not less than 45 days[295] before the date of the refund check. If the overpayment is to be credited or offset against some other liability, interest will accrue until the date it is so credited or offset.

A payment is not considered made by the taxpayer earlier than the time the taxpayer files a return showing the liability. In MNOPF Trustees, Ltd. V. United States,[296] the Federal Circuit held that overpayment interest accrued on the taxes unnecessarily withheld from the date that the withholdings were paid to the Service, because MNOPF was a tax-exempt organization, and, therefore, was not required to file tax returns. As a result, the court rejected arguments by the government that interest commenced no earlier than the filing of the refund claims. The court reasoned that sections 6611(d) and 6513(b)(3) did not apply because those sections only relate to taxable income and the taxpayer was exempt from federal taxation. Instead, the court held that the organization's overpayment was deemed paid, pursuant to section 6611(b)(2), on the date the withholding agent filed the returns reporting the withheld taxes.

No interest accrues on an overpayment if the IRS makes the refund within 45 days of the later of the filing or the due date of the return showing the refund. If the IRS fails to make the refund within such 45-day period, interest is required to be paid for the entire period of the overpayment. For example, an individual taxpayer files his return on April 15th, properly showing a refund due of $10,000. If the IRS pays the refund within 45 days, no interest on the

[292] Sec. 6622.

[293] Sec. 6621(d).

[294] Sec. 6621.

[295] The grace period afforded the government was originally included as section 3771(b)(2) in the Internal Revenue Code of 1939 and was only 30-days. The grace period provides a period of time within which the IRS can transmit the refund information to the Financial Management Service of the Treasury Department, which is the agency that actually issues the refund checks.

[296] 123 F.3d 1460, 1465 (Fed. Cir. 1997).

overpayment will be required. However, if the IRS does not pay the refund until the 46th day, interest will be required from April 15th.

Certification of foreign status and reporting by U.S. withholding agents

The U.S. withholding tax rules are administered through a system of self-certification. Thus, a nonresident investor seeking to obtain withholding tax relief for U.S.-source investment income typically must provide a certification, on Internal Revenue Service ("IRS") Form W-8 to the withholding agent in order to establish foreign status and eligibility for an exemption or reduced rate. Provision of the IRS Form W-8 also establishes an exemption from the rules that apply to many U.S. persons governing information reporting on IRS Form 1099 and backup withholding (discussed below).[297]

There are four relevant types of IRS Forms W-8.[298] Three of these forms are designed to be provided to the withholding agent by the beneficial owner of a payment of U.S.-source income:[299] (1) the IRS Form W-8BEN, which is provided by a beneficial owner of U.S.-source non-effectively-connected income; (2) the IRS Form W-8ECI, which is provided by a beneficial owner of U.S.-source effectively-connected income;[300] and (3) the IRS Form W-8EXP, which is provided by a beneficial owner of U.S.-source income that is an exempt organization or foreign government.[301] Each of these forms requires that the beneficial owner provide its name and address and certify that the beneficial owner is not a U.S. person. The IRS Form W-8BEN also includes a certification of eligibility for treaty benefits (for completion where applicable). All certifications on IRS Forms W-8 are made under penalties of perjury.

The fourth type of IRS Form W-8 is the IRS Form W-8IMY, which is provided by a payee that receives a payment of U.S.-source income as an intermediary for the beneficial owner of that income. The intermediary's IRS Form W-8IMY must be accompanied by an IRS Form

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[297] See Treas. Reg. sec. 1.1441-1(b)(5).

[298] A fifth type of IRS Form W-8, the W-8CE, is filed to provide the payor with notice of a taxpayer's expatriation.

[299] The United States imposes tax on the beneficial owner of income, not its formal recipient. For example, if a U.S. citizen owns securities that are held in "street" name at a brokerage firm, that U.S. citizen (and not the brokerage firm nominee) is treated as the beneficial owner of the securities. A corporation (and not its shareholders) ordinarily is treated as the beneficial owner of the corporation's income. Similarly, a foreign complex trust ordinarily is treated as the beneficial owner of income that it receives, and a U.S. beneficiary or grantor is not subject to tax on that income unless and until he receives a distribution.

[300] The IRS Form W-8ECI requires that the beneficial owner specify the items of income to which the form is intended to apply and certify that those amounts are effectively connected with the conduct of a trade or business in the United States and includible in the beneficial owner's gross income for the taxable year.

[301] The IRS Form W-8EXP requires that the beneficial owner certify as to its qualification as a foreign government, an international organization, a foreign central bank of issue or a foreign tax-exempt organization, in each case meeting certain requirements.

W-8BEN, W-8EXP, or W-8ECI, as applicable,[302] furnished by the beneficial owner, unless the intermediary is a qualified intermediary ("QI"), a withholding foreign partnership, or a withholding foreign trust. The rules applicable to qualified intermediaries are discussed below. A withholding foreign partnership or trust is a foreign partnership or trust that has entered into an agreement with the IRS to collect appropriate IRS Forms W-8 from its partners or beneficiaries and act as a U.S. withholding agent with respect to those persons.[303]

<u>Information reporting and backup withholding with respect to U.S. persons</u>

Every person engaged in a trade or business must file with the IRS an information return on IRS Form 1099 (or, for wages or other compensation, on IRS Form W-2) for payments of certain amounts totaling at least $600 that it makes to another person in the course of its trade or business.[304] Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock).[305] In general, the requirement to file IRS Form 1099 applies with respect to amounts paid to U.S. persons and is linked to the backup withholding rules of section 3406. Thus, to avoid backup withholding, a U.S. payee (other than exempt recipients, including corporations and financial institutions) of interest, dividends, or gross proceeds generally must furnish to the payor an IRS Form W-9 providing that person's name and taxpayer identification number.[306] That information is then used to complete the IRS Form 1099.

If an IRS Form W-9 is not provided by a U.S. payee (other than payees exempt from reporting), the payor is required to impose a backup withholding tax of 28 percent of the gross amount of the payment.[307] The backup withholding tax may be credited by the payee against regular income tax liability.[308] This combination of reporting and backup withholding is designed to ensure that U.S. persons not exempt from reporting pay tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

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[302] In limited cases, the intermediary may furnish documentary evidence, other than the IRS Form W-8, of the status of the beneficial owner.

[303] Rev. Proc. 2003-64, 2003-32 I.R.B. 306 (July 10, 2003), provides procedures for qualification as a withholding foreign partnership or withholding foreign trust in addition to providing model withholding agreements.

[304] Sec. 6041; Treas. Reg. secs. 1.6041-1, 1.6041-2.

[305] See secs. 6042 (dividends), 6045 (broker reporting), 6049 (interest), and the corresponding Treasury regulations.

[306] See Treas. Reg. secs. 31.3406(d)-1, 31.3406(h)-3.

[307] Sec. 3406(a)(1).

[308] Sec. 3406(h)(10).

As described above, amounts paid to foreign persons are generally exempt from information reporting on IRS Form 1099. Foreign persons are subject to a separate information reporting requirement linked to the nonresident withholding provisions of chapter 3 of the Code.

In the case of U.S. source investment income, the information reporting, backup withholding and nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.[309] As a practical matter, however, these reporting and withholding requirements are difficult to enforce with respect to foreign financial institutions, unless these institutions have some connection to the United States, e.g., the institution is a foreign subsidiary of a U.S. financial institution, or the foreign financial institution is doing business in the United States. Moreover, to the extent that these rules apply to foreign financial institutions, the rules may also be modified by QI agreements between the institutions and the IRS, as described below.

<u>The qualified intermediary program</u>

A QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization or a foreign branch of a U.S. financial institution that has entered into a withholding and reporting agreement (a "QI agreement") with the IRS.[310]

A foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other withholding agent of U.S.-source investment-type income to establish the customer's eligibility for an exemption from, or reduced rate of, U.S. withholding tax.[311] Instead, the QI is permitted to establish for itself the eligibility of its customers for an exemption or reduced rate, based on an IRS Form W-8 or W-9, or other specified documentary evidence, and information as to residence obtained under the know-your-customer rules to which the QI is subject in its home jurisdiction

[309] See Treas. Reg. secs. 1.1441-7(a) (definition of withholding agent includes foreign persons), 31.3406(a)-2 (payor for backup withholding purposes means the person (the payor) required to file information returns for payments of interest, dividends, and gross proceeds (and other amounts)), 1.6049-4(a)(2) (definition of payor for interest reporting purposes does not exclude foreign persons), 1.6042-3(b)(2) (payor for dividend reporting purposes has the same meaning as for interest reporting purposes), 1.6045-1(a)(1) (brokers required to report include foreign persons). But see Treas. Reg. secs. 1.6049-5(b) (exception for interest from sources outside the U.S. paid outside the U.S. by a non-U.S. payor or a non-U.S. middleman), 1.6045-1(g)(1)(i) (exception for sales effected at an office outside the U.S. by a non-U.S. payor or a non-U.S. middleman), 1.6042-3(b)(1)(iv) (exceptions for distributions from sources outside the U.S. by a non-U.S. payor or a non-U.S. middleman).

[310] The definition also includes: a foreign branch or office of a U.S. financial institution or U.S. clearing organization; a foreign corporation for purposes of presenting income tax treaty claims on behalf of its shareholders; and any other person acceptable to the IRS, in each case that such person has entered into a withholding agreement with the IRS. Treas. Reg. sec. 1.1441-1(e)(5)(ii).

[311] U.S. withholding agents are allowed to rely on a QI's IRS Form W-8IMY without any underlying beneficial owner documentation. By contrast, nonqualified intermediaries are required both to provide an IRS Form W-8IMY to a U.S. withholding agent and to forward with that document IRS Forms W-8 or W-9 or other specified documentation for each beneficial owner.

as approved by the IRS or as specified in the QI agreement.[312] The QI certifies as to eligibility on behalf of its customers, and provides withholding rate pool information to the U.S. withholding agent as to the portion of each payment that qualifies for an exemption or reduced rate of withholding.

The IRS has published a model QI agreement for foreign financial institutions.[313] A prospective QI must submit an application to the IRS providing specified information, and any additional information and documentation requested by the IRS. The application must establish to the IRS's satisfaction that the applicant has adequate resources and procedures to comply with the terms of the QI agreement.

Before entering into a QI agreement that provides for the use of documentary evidence obtained under a country's know-your-customer rules, the IRS must receive (1) that country's know-your-customer practices and procedures for opening accounts and (2) responses to 18 related items.[314] If the IRS has already received this information, a particular prospective QI need not submit it again. The IRS has received such information and has approved know-your-customer rules in 59 countries.

A foreign financial institution or other eligible person becomes a QI by entering into an agreement with the IRS. Under the agreement, the financial institution acts as a QI only for accounts that the financial institution has designated as QI accounts. A QI is not required to act as a QI for all of its accounts; however, if a QI designates an account as one for which it will act as a QI, it must act as a QI for all payments made to that account.

The model QI agreement describes in detail the QI's withholding and reporting obligations. Certain key aspects of the model agreement are described below.[315]

<u>Withholding and reporting responsibilities</u>

As a technical matter, all QIs are withholding agents for purposes of the nonresident withholding and reporting rules, and payors (who are required to withhold and report) for purposes of the backup withholding and IRS Form 1099 information reporting rules. However, under the QI agreement, a QI may choose not to assume primary responsibility for nonresident withholding. In that case, the QI is not required to withhold on payments made to non-U.S. customers, or to report those payments on IRS Form 1042-S. Instead, the QI must provide a U.S.

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[312] See Rev. Proc. 2000-12, 2000-1 C.B. 387, QI agreement secs. 2.12, 2.12, 5.03, 6.01.

[313] Rev. Proc. 2000-12, 2000-1 C.B. 387, *supplemented by* Announcement 2000-50, 2000-1 C.B. 998, and *modified by* Rev. Proc. 2003-64, 2003-2 C.B. 306, and Rev. Proc. 2005-77, 2005-2 C.B. 1176. The QI agreement applies only to foreign financial institutions, foreign clearing organizations, and foreign branches or offices of U.S. financial institutions or U.S. clearing organizations. However, the principles of the QI agreement may be used to conclude agreements with other persons defined as QIs.

[314] See Rev. Proc. 2000-12, 2000-1 C.B. 387, sec. 3.02.

[315] Additional detail can be found in Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities* (JCX-65-08), July 23, 2008.

withholding agent with an IRS Form W-8IMY that certifies as to the status of its (unnamed) non-U.S. account holders and withholding rate pool information.

Similarly, a QI may choose not to assume primary responsibility for IRS Form 1099 reporting and backup withholding. In that case, the QI is not required to backup withhold on payments made to U.S. customers or to file IRS Forms 1099. Instead, the QI must provide a U.S. payor with an IRS Form W-9 for each of its U.S. non-exempt recipient account holders (i.e., account holders that are U.S. persons not generally exempt from IRS Form 1099 reporting and backup withholding).[316]

A QI may elect to assume primary nonresident withholding and reporting responsibility, primary backup withholding and IRS Form 1099 reporting responsibility, or both.[317] A QI that assumes such responsibility is subject to all of the related obligations imposed by the Code on U.S. withholding agents or payors. The QI must also provide the U.S. withholding agent (or U.S. payor) additional information about the withholding rates to enable the withholding agent to appropriately withhold and report on payments made through the QI. These rates can be supplied with respect to withholding rate pools that aggregate payments of a single type of income (e.g., interest or dividends) that is subject to a single rate of withholding.

If a U.S. non-exempt recipient has not provided a IRS Form W-9, the QI must disclose the name, address, and taxpayer identification number ("TIN") (if available) to the withholding agent (and the withholding agent must apply backup withholding). However, no such disclosure is necessary if the QI is, under local law, prohibited from making the disclosure and the QI has followed certain procedural requirements (including providing for backup withholding, as described further below).

Documentation of account holders

A QI agrees to use its best efforts to obtain documentation regarding the status of their account holders in accordance with the terms of its QI agreement.[318] A QI must apply presumption rules[319] unless a payment can be reliably associated with valid documentation from

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[316] Regardless of whether a QI assumes primary Form 1099 reporting and backup withholding responsibility, the QI is responsible for IRS Form 1099 reporting and backup withholding on certain reportable payments that are not reportable amounts. See Rev. Proc. 2000-12, 2001-1 C.B. 387, QI agreement sec. 2.43 (defining reportable amount), sec. 2.44 (defining reportable payment), sec. 3.05, sec. 8.04. The reporting responsibility differs depending on whether the QI is a U.S. payor or a non-U.S. payor. Examples of payments for which the QI assumes primary IRS Form 1099 reporting and backup withholding responsibility include certain broker proceeds from the sale of certain assets owned by a U.S. non-exempt recipient and payments of certain foreign-source income to a U.S. non-exempt recipient if such income is paid in the United States or to an account maintained in the United States.

[317] To the extent that a QI assumes primary responsibility for an account, it must do so for all payments made by the withholding agent to that account. See Rev. Proc. 2000-12, QI agreement sec. 3.

[318] See Rev. Proc. 2000-12, QI agreement sec. 5.

[319] The QI agreement contains its own presumption rules. See Rev. Proc. 2000-12, QI agreement sec. 5.13(C). An amount subject to withholding that is paid outside the United States to an account maintained outside

the account holder. The QI agrees to adhere to the know-your-customer rules set forth in the QI agreement with respect to the account holder from whom the evidence is obtained.

A QI may treat an account holder as a foreign beneficial owner of an amount if the account holder provides a valid IRS Form W-8 (other than an IRS Form W-8IMY) or valid documentary evidence that supports the account holder's status as a foreign person.[320] With such documentation, a QI generally may treat an account holder as entitled to a reduced rate of withholding if all the requirements for the reduced rate are met and the documentation supports entitlement to a reduced rate. A QI may not reduce the rate of withholding if the QI knows that the account holder is not the beneficial owner of a payment to the account.

If a foreign account holder is the beneficial owner of a payment, then a QI may shield the account holder's identity from U.S. custodians and the IRS. If a foreign account holder is not the beneficial owner of a payment (for example, because the account holder is a nominee), the account holder must provide the QI with an IRS Form W-8IMY for itself along with specific information about each beneficial owner to which the payment relates. A QI that receives this information may shield the account holder's identity from a U.S. custodian, but not from the IRS.[321]

In general, if an account holder is a U.S. person, the account holder must provide the QI with an IRS Form W-9 or appropriate documentary evidence that supports the account holder's status as a U.S. person. However, if a QI does not have sufficient documentation to determine whether an account holder is a U.S. or foreign person, the QI must apply certain presumption rules detailed in the QI agreement. These presumption rules may not be used to grant a reduced rate of nonresident withholding; instead they merely determine whether a payment should be subject to full nonresident withholding (at a 30-percent rate), subject to backup withholding (at a 28-percent rate), or treated as exempt from backup withholding.

In general, under the QI agreement presumptions, U.S.-source investment income that is paid outside the United States to an offshore account is presumed to be paid to an undocumented foreign account holder. A QI must treat such a payment as subject to withholding at a 30-percent rate and report the payment to an unknown account holder on IRS Form 1042-S. However, most U.S.-source deposit interest and interest or original issue discount on short-term obligations that

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the United States is presumed made to an undocumented foreign account holder (i.e., subject to 30-percent withholding). Payments of U.S. source deposit interest and certain other U.S. source interest and original issue discount paid outside of the United States to an offshore account is presumed made to an undocumented U.S. non-exempt account holder (i.e., subject to backup withholding). For payments of foreign source income, broker proceeds and certain other amounts, the QI can assume such payments are made to an exempt recipient if the amounts are paid outside the United States to an account maintained outside the United States.

[320] Documentary evidence is any documentation obtained under know-your-customer rules per the QI agreement, evidence sufficient to establish a reduced rate of withholding under Treas. Reg. sec. 1.1441-6, and evidence sufficient to establish status for purposes of chapter 61 under Treas. Reg. 1.6049-5(c). See Rev. Proc. 2000-12, QI agreement sec. 2.12.

[321] This rule restricts one of the principal benefits of the QI regime, nondisclosure of account holders, to financial institutions that have assumed the documentation and other obligations associated with QI status.

is paid outside the United States to an offshore account is presumed made to an undocumented U.S. non-exempt recipient account holder and thus is subject to backup withholding at a 28-percent rate.[322] Importantly, both foreign-source income and broker proceeds are presumed to be paid to a U.S. exempt recipient (and thus are exempt from both nonresident and backup withholding) when such amounts are paid outside the United States to an offshore account.

QI information return requirements

A QI must file IRS Form 1042 by March 15 of the year following any calendar year in which the QI acts as a QI. A QI is not required to file IRS Forms 1042-S for amounts paid to each separate account holder, but instead files a separate IRS Form 1042-S for each type of reporting pool.[323] A QI must file separate IRS Forms 1042-S for amounts paid to certain types of account holders, including: (1) other QIs which receive amounts subject to foreign withholding; (2) each foreign account holder of a nonqualified intermediary or other flow-through entity to the extent that the QI can reliably associate such amounts with valid documentation; and (3) unknown recipients of amounts subject to withholding paid through a nonqualified intermediary or other flow-through entity to the extent the QI cannot reliably associate such amounts with valid documentation. The IRS Form 1042 must also include an attachment setting forth the aggregate amounts of reportable payments paid to U.S. non-exempt recipient account holders, and the number of such account holders, whose identity is prohibited by foreign law (including by contract) from disclosure.[324]

A QI has specified IRS Form 1099[325] filing requirements including: (1) filing an aggregate IRS Form 1099 for each type of reportable amount paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (2) filing an aggregate IRS Form 1099 for reportable payments other than reportable amounts[326] paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (3) filing separate IRS Forms 1099 for reportable amounts paid to U.S. non-exempt recipient account holders for whom the QI has not provided an IRS Form W-9 or identifying information to a withholding agent; (4) filing separate IRS Forms 1099 for reportable payments

[322] These amounts are statutorily exempt from nonresident withholding when paid to non-U.S. persons.

[323] A reporting pool consists of income that falls within a particular withholding rate and within a particular income code, exemption code, and recipient code as determined on IRS Form 1042-S.

[324] For undisclosed accounts, QIs must separately report each type of reportable payment (determined by reference to the types of income reported on IRS Forms 1099) and the number of undisclosed account holders receiving such payments.

[325] If the QI is required to file IRS Forms 1099, it must file the appropriate form for the type of income paid (e.g., IRS Form 1099-DIV for dividends, IRS Form 1099-INT for interest, and IRS Form 1099-B for broker proceeds).

[326] The term reportable amount generally includes those amounts that would be reported on IRS Form 1042-S if the amount were paid to a foreign account holder. The term reportable payment generally refers to amounts subject to backup withholding, but it has a different meaning depending upon the status of the QI as a U.S. or non-U.S. payor.

other than reportable amounts paid to U.S. non-exempt recipient account holders; (5) filing separate IRS Forms 1099 for reportable amounts paid to U.S. non-exempt recipient accounts holders for which the QI has assumed primary IRS Form 1099 reporting and backup withholding responsibility; and (6) filing separate IRS Forms 1099 for reportable payments to an account holder that is a U.S. person if the QI has applied backup withholding and the amount was not otherwise reported on an IRS Form 1099.

Foreign law prohibition of disclosure

The QI agreement includes procedures to address situations in which foreign law (including by contract) prohibits the QI from disclosing the identities of U.S. non-exempt recipients (such as individuals). Separate procedures are provided for accounts established with a QI prior to January 1, 2001, and for accounts established on or after January 1, 2001.

Accounts established prior to January 1, 2001.–For accounts established prior to January 1, 2001, if the QI knows that the account holder is a U.S. non-exempt recipient, the QI must (1) request from the account holder the authority to disclose its name, address, TIN (if available), and reportable payments; (2) request from the account holder the authority to sell any assets that generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to provide an IRS Form W-9 completed by the account holder. The QI must make these requests at least two times during each calendar year and in a manner consistent with the QI's normal communications with the account holder (or at the time and in the manner that the QI is authorized to communicate with the account holder). Until the QI receives a waiver on all prohibitions against disclosure, authorization to sell all assets that generate, or could generate, reportable payments, or a mandate from the account holder to provide an IRS Form W-9, the QI must backup withhold on all reportable payments paid to the account holder and report those payments on IRS Form 1099 or, in certain cases, provide another withholding agent with all of the information required for that withholding agent to backup withhold and report the payments on IRS Form 1099.

Accounts established on or after January 1, 2001.–For any account established by a U.S. non-exempt recipient on or after January 1, 2001, the QI must (1) request from the account holder the authority to disclose its name, address, TIN (if available), and reportable payments; (2) request from the account holder, prior to opening the account, the authority to exclude from the account holder's account any assets that generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to transfer an IRS Form W-9 completed by the account holder.

If a QI is authorized to disclose the account holder's name, address, TIN, and reportable amounts, it must obtain a valid IRS Form W-9 from the account holder, and, to the extent the QI does not have primary IRS Form 1099 and backup withholding responsibility, provide the IRS Form W-9 to the appropriate withholding agent promptly after obtaining the form. If an IRS Form W-9 is not obtained, the QI must provide the account holder's name, address, and TIN (if available) to the withholding agents from whom the QI receives reportable amounts on behalf of the account holder, together with the withholding rate applicable to the account holder. If a QI is not authorized to disclose an account holder's name, address, TIN (if available), and reportable amounts, but is authorized to exclude from the account holder's account any assets that generate, or could generate, reportable payments, the QI must follow procedures designed to ensure that it will not hold any assets that generate, or could generate, reportable payments in the account holder's account.[327]

External audit procedures

The IRS generally does not audit a QI with respect to withholding and reporting obligations covered by a QI agreement if an approved external auditor conducts an audit of the QI. An external audit must be performed in the second and fifth full calendar years in which the QI agreement is in effect. In general, the IRS must receive the external auditor's report by June 30 of the year following the year being audited.

Requirements for the external audit are provided in the QI agreement. In general, the QI must permit the external auditor to have access to all relevant records of the QI, including information regarding specific account holders. In addition, the QI must permit the IRS to communicate directly with the external auditor, review the audit procedures followed by the external auditor, and examine the external auditor's work papers and reports.

In addition to the external audit requirements set forth in the QI agreement, the IRS has issued further guidance (the "QI audit guidance") for an external auditor engaged by a QI to verify the QI's compliance with the QI agreement.[328] An external auditor must conduct its audit in accordance with the procedures described in the QI agreement. However, the QI audit guidance is intended to assist the external auditor in understanding and applying those procedures. The QI audit guidance does not amend, modify, or interpret the QI agreement.

Term of a QI agreement

A QI agreement expires on December 31 of the fifth full calendar year after the year in which the QI agreement first takes effect, although it may be renewed. Either the IRS or the QI may terminate the QI agreement prior to its expiration by delivering a notice of termination to the other party. However, the IRS generally does not terminate a QI agreement unless there is a significant change in circumstances or an event of default occurs, and the IRS determines that the change in circumstance or event of default warrants termination. In the event that an event of default occurs, a QI is given an opportunity to cure it within a specified time.

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[327] Under both of these procedures, if the QI is a non-U.S. payor, a U.S. non-exempt recipient may effectively avoid disclosure and backup withholding by investing in assets that generate solely non-reportable payments such as foreign source income (such as bonds issued by a foreign government) paid outside of the United States.

[328] Rev. Proc. 2002-55, 2002-2 C.B. 435.

Know-your-customer due diligence requirements

United States

The U.S. know-your-customer rules[329] require financial institutions[330] to develop and maintain a written customer identification program and anti-money laundering policies and procedures. Additionally, financial institutions must perform customer due diligence. The due diligence requirements are enhanced where the account or the financial institution has a higher risk profile.[331]

A customer identification program at a minimum requires the financial institution to collect the name, date of birth (for individuals), address,[332] and identification number[333] for new customers. In fulfilling their customer due diligence requirements, financial institutions are required to verify enough customer information to enable the financial institution to form a "reasonable belief that it knows the true identity of each customer."[334]

In many cases the know-your-customer rules do not require financial institutions to look through an entity to determine its ultimate ownership.[335] However, based on the financial institution's risk assessment, the financial institution may need to obtain information about individuals with authority or control over such an account in order to verify the identity of the customer.[336] A financial institution's customer due diligence must include gathering sufficient

[329] The U.S. know-your-customer rules are primarily found in the Bank Secrecy Act of 1970 and in Title III, The International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 of the USA PATRIOT Act.

[330] The term financial institution is broadly defined under 31 U.S.C. sec. 5312(a)(2) or (c)(1) and includes U.S. banks and agencies or branches of foreign banks doing business in the United States, insurance companies, credit unions, brokers and dealers in securities or commodities, money services businesses, and certain casinos.

[331] Relevant risks include the types of accounts held at the financial institution, the methods available for opening accounts, the types of customer identification information available, and the size, location, and customer base of the financial institution. 31 C.F.R. sec. 103.121(b)(2).

[332] For a person other than an individual the address is the principal place of business, local office, or other physical location. 31 C.F.R. sec. 103.121(b)(2)(i)(3)(iii).

[333] For a U.S. person the identification number is the TIN. For a non-U.S. person the identification number could be a TIN, passport number, alien identification number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. 31 C.F.R. sec. 103.121(b)(2)(i)(4).

[334] See 31 C.F.R. sec. 103.121(b)(2).

[335] For example, a financial institution is not "required to look through trust, escrow, or similar accounts to verify the identities of beneficiaries and instead will only be required to verify the identity of the named accountholder." See 68 Fed. Reg. 25,090, 25,094 (May 9, 2003).

[336] See 31 C.F.R. sec. 103.121(b)(2)(ii)(C).

information on a business entity and its owners for the financial institution to understand and assess the risks of the account relationship.[337]

Enhanced due diligence is required if customers are deemed to be of higher risk, and is mandated for certain types of accounts including foreign correspondent accounts, private banking accounts, and accounts for politically exposed persons. Private banking accounts are considered to be of significant risk and enhanced due diligence requires identification of nominal and beneficial owners for these accounts.[338]

Financial institutions must maintain records for a minimum of five years after the account is closed or becomes dormant. They are required to monitor accounts including the frequency, size and ultimate destinations of transfers and must update customer due diligence and enhanced due diligence when there are significant changes to the customer's profile (for example, volume of transaction activity, risk level, or account type).

European Union Third Money Laundering Directive

The European Union ("EU") Third Money Laundering Directive[339] is also applicable to a broad range of persons including credit institutions and financial institutions as well as to persons acting in the exercise of certain professional activities.[340] It requires systems, adequate policies and procedures for customer due diligence, reporting, record keeping, internal controls, risk assessment, risk management, compliance management, and communication. Required customer due diligence measures go further than the know-your-customer rules in the United States in requiring identification and verification of the beneficial owner and an understanding of the ownership and control structure of the customer in addition to the basic customer identification program and customer due diligence requirements.

A beneficial owner is defined as the natural person who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted. For corporations, beneficial owner includes: (1) the natural person or persons who ultimately owns or controls a legal entity through direct or indirect ownership or control over a sufficient percentage (25 percent plus one share) of the shares or voting rights in that legal entity; and 2)

[337] In order to assess the risk of the account relationship, a financial institution may need to ascertain the type of business, the purpose of the account, the source of the account funds, and the source of the wealth of the owner or beneficial owner of the entity.

[338] 31 C.F.R. sec. 103.178. A private banking account is an account that (1) requires a minimum deposit of not less than 1 million dollars; (2) is established for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account; and (3) is administered or managed by an officer, employee or agent of the financial institution. Beneficial owner for these purposes is defined as an individual who has a level of control over, or entitlement to the funds or assets in the account. 31 C.F.R. secs. 103.175(b), 103.175(o).

[339] Directive 2005/60/EC of the European Parliament and of the Council, October 26, 2005 ("EU Third Money Laundering Directive").

[340] The directive applies to auditors, accountants, tax advisors, notaries, legal professionals, real estate agents, certain persons trading in goods (cash transactions in excess of EUR 15,000), and casinos.

the natural person or persons who otherwise exercises control over the management of the legal entity.[341] For foundations, trusts, and like entities that administer and distribute funds, beneficial owner includes: (1) in cases in which future beneficiaries are determined, a natural person who is the beneficiary of 25 percent or more of the property; (2) in cases in which future beneficiaries have yet to be determined, the class of person in whose main interest the legal arrangement is set up or operates; and (3) natural person who exercises control over 25 percent or more of the property.[342] Under the EU Third Money Laundering Directive, EU member states generally must require identification of the customer and any beneficial owners before the establishment of a business relationship.[343]

The EU Third Money Laundering Directive requires ongoing account monitoring including scrutiny of transactions throughout the course of relationship to ensure that the transactions conducted are consistent with the customer and the business risk profile. It requires documents and other information to be updated and requires performance of customer due diligence procedures at appropriate times (such as a change in account signatories or change in the use of an account) for existing customers on a risk sensitive basis. Records must be maintained for up to five years after the customer relationship has ended.

Explanation of Provision

The provision adds a new chapter 4 to the Code that provides for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by specified United States persons or by United States owned foreign entities. The provision establishes rules for withholdable payments to foreign financial institutions and for withholdable payments to other foreign entities.

Withholdable payments to foreign financial institutions

The provision requires a withholding agent to deduct and withhold a tax equal to 30 percent on any withholdable payment made to a foreign financial institution if the foreign financial institution does not meet certain requirements. Specifically, withholding is generally not required if an agreement is in effect between the foreign financial institution and the Secretary under which the institution agrees to:

1. Obtain information regarding each holder of each account maintained by the institution as is necessary to determine which accounts are United States accounts;

2. Comply with verification and due diligence procedures as the Secretary requires with respect to the identification of United States accounts;

[341] EU Third Money Laundering Directive Art. 3(6)(a). Inquiries into beneficial ownership generally may stop at the level of any owner that is a company listed on a regulated market.

[342] EU Third Money Laundering Directive Art. 3(6)(b).

[343] EU Third Money Laundering Directive Art. 9.

3. Report annually certain information with respect to any United States account maintained by such institution;

4. Deduct and withhold 30 percent from any passthru payment that is made to a (1) recalcitrant account holder or another financial institution that does not enter into an agreement with the Secretary, or (2) foreign financial institution that has elected to be withheld upon rather than to withhold with respect to the portion of the payment that is allocable to a recalcitrant account holder or to foreign financial institutions that do not have an agreement with the Secretary.

5. Comply with requests by the Secretary for additional information with respect to any United States account maintained by such institution; and

6. Attempt to obtain a waiver in any case in which any foreign law would (but for a waiver) prevent the reporting of information required by the provision with respect to any United States account maintained by such institution, and if a waiver is not obtained from each account holder within a reasonable period of time, to close the account.

If the Secretary determines that the foreign financial institution is out of compliance with the agreement, the agreement may be terminated by the Secretary. The provision applies with respect to United States accounts maintained by the foreign financial institution and, except as provided by the Secretary, to United States accounts maintained by each other financial institution that is a member of the same expanded affiliated group (other than any foreign financial institution that also enters into an agreement with the Secretary).

It is expected that in complying with the requirements of this provision, the foreign financial institution and the other members of the same expanded affiliated group comply with know-your-customer, anti-money laundering, anti-corruption, or other similar rules to which they are subject, as well as with such procedures and rules as the Secretary may prescribe, both with respect to due diligence by the foreign financial institution and verification by or on behalf of the IRS to ensure the accuracy of the information, documentation, or certification obtained to determine if the account is a United States account. The Secretary may use existing know-your-customer, anti-money laundering, anti-corruption, and other regulatory requirements as a basis in crafting due diligence and verification procedures in jurisdictions where those requirements provide reasonable assurance that the foreign financial institution is in compliance with the requirements of this provision.

The provision allowing for withholding on payments made to an account holder that fails to provide the information required under this provision is not intended to create an alternative to information reporting. It is anticipated that the Secretary may require, under the terms of the agreement, that the foreign financial institution achieve certain levels of reporting and make reasonable attempts to acquire the information necessary to comply with the requirements of this section or to close accounts where necessary to meet the purposes of this provision. It is anticipated that the Secretary may also require, under the terms of the agreement, that, in the case of new accounts, the foreign financial institution may not withhold as an alternative to collecting the required information.

A foreign financial institution may be deemed, by the Secretary, to meet the requirements of this provision if: (1) the institution complies with procedures prescribed by the Secretary to ensure that the institution does not maintain United States accounts, and meets other requirements as the Secretary may prescribe with respect to accounts of other foreign financial institutions; or (2) the institution is a member of a class of institutions for which the Secretary has determined that the requirements are not necessary to carry out the purposes of this provision. For instance, it is anticipated that the Secretary may provide rules that would permit certain classes of widely held collective investment vehicles to be deemed to meet the requirements of this provision. It is anticipated that a foreign financial institution that has an agreement with the Secretary may meet the requirements under this provision with respect to certain members of its expanded affiliated group if the affiliated foreign financial institution complies with procedures prescribed by the Secretary and does not maintain United States accounts. Additionally, the Secretary may identify classes of institutions that are deemed to meet the requirements of this provision if such institutions are subject to similar due diligence and reporting requirements under other provisions in the Code. Such institutions may include certain controlled foreign corporations owned by U.S. financial institutions and certain U.S. branches of foreign financial institutions that are treated as U.S. payors under present law.

Under the provision, a foreign financial institution may elect to have a U.S. withholding agent or a foreign financial institution that has entered into an agreement with the Secretary withhold on payments made to the electing foreign financial institution rather than acting as a withholding agent for the payments it makes to other foreign financial institutions that either do not enter into agreements with the Secretary or that themselves have elected not to act as a withholding agent, or for payments it makes to account holders that fail to provide required information. If the election under this provision is made, the withholding tax will apply with respect to any payment made to the electing foreign financial institution to the extent the payment is allocable to accounts held by foreign financial institutions that do not enter into an agreement with the Secretary or to payments made to recalcitrant account holders.

A payment may be allocable to accounts held by a recalcitrant account holder or a foreign financial institution that does not meet the requirements of this section either as a result of such person holding an account directly with the electing foreign financial institution, or in relation to an indirect account held through other foreign financial institutions that either do not enter into an agreement with the Secretary or are themselves electing foreign financial institutions.

The electing foreign financial institution must notify the withholding agent of its election and must provide information necessary for the withholding agent to determine the appropriate amount of withholding. The information may include information regarding the amount of any payment that is attributable to a withholdable payment and information regarding the amount of any payment that is allocable to recalcitrant account holders or to foreign financial institutions that have not entered into agreements with the Secretary. Additionally, the electing foreign financial institution must waive any right under a treaty with respect to an amount deducted and withheld pursuant to the election. To the extent provided by the Secretary, the election may be made with respect to certain classes or types of accounts.

A foreign financial institution meets the annual information reporting requirements under the provision by reporting the following information:

1. The name, address, and TIN of each account holder that is a specified United States person;

2. The name, address, and TIN of each substantial United States owner of any account holder that is a United States owned foreign entity;

3. The account number;

4. The account balance or value (determined at such time and in such manner as the Secretary provides); and

5. The gross receipts and gross withdrawals or payments from the account (determined for such period and in such manner as the Secretary may provide).

This information is required with respect to each United States account maintained by the foreign financial institution and, except as provided by the Secretary, each United States account maintained by each other foreign financial institution that is a member of the same expanded affiliated group (other than any foreign financial institution that also enters into an agreement with the Secretary).

Alternatively, a foreign financial institution may make an election and report under sections 6041 (information at source), 6042 (returns regarding payments of dividends and corporate earnings and profits), 6045 (returns of brokers), and 6049 (returns regarding payments of interest), as if such foreign financial institution were a U.S. person (i.e., elect to provide full IRS Form 1099 reporting under these sections). Under this election, the foreign financial institution reports on each account holder that is a specified United States person or United States owned foreign entity as if the holder of the account were a natural person and citizen of the United States. As a result, both U.S.- and foreign-source amounts (including gross proceeds) are subject to reporting under this election regardless of whether the amounts are paid inside or outside the United States. If a foreign financial institution makes this election, the institution is also required to report the following information with respect to each United States account maintained by the institution: (1) the name, address, and TIN of each account holder that is a specified United States person; (2) the name, address, and TIN of each substantial United States owner of any account holder that is a United States owned foreign entity; and (3) the account number. This election can be made by a foreign financial institution even if other members of its expanded affiliated group do not make the election. The Secretary has authority to specify the time and manner of the election and to provide other conditions for meeting the reporting requirements of the election.

Foreign financial institutions that have entered into QI or similar agreements with the Secretary, under section 1441 and the regulations thereunder, are required to meet the requirements of this provision in addition to any other requirements imposed under the QI or similar agreement.

Under the provision, a United States account is any financial account held by one or more specified United States persons or United States owned foreign entities. Depository accounts are not treated as United States accounts for these purposes if (1) each holder of the account is a natural person and (2) the aggregate value of all depository accounts held (in whole or in part) by each holder of the account maintained by the financial institution does not exceed $50,000. A foreign financial institution may, however, elect to include all depository accounts held by U.S. individuals as United States accounts. To the extent provided by the Secretary, financial institutions that are members of the same expanded affiliated group may be treated as a single financial institution for purposes of determining the aggregate value of depository accounts maintained at the financial institution.

In addition, a financial account is not a United States account if the account is held by a foreign financial institution that has entered into an agreement with the Secretary or is otherwise subject to information reporting requirements that the Secretary determines would make the reporting duplicative. It is anticipated that the Secretary may exclude certain financial accounts held by bona fide residents of any possession of the United States maintained by a financial organization organized under the laws of the possession if the Secretary determines that such reporting is not necessary to carry out the purposes of this provision.

A financial account is any depository or custodial account maintained by a foreign financial institution and, except as otherwise provided by the Secretary, any equity or debt interest in a foreign financial institution (other than interests that are regularly traded on an established securities market). Any equity or debt interest that is treated as a financial account with respect to any financial institution is treated for purposes of this provision as maintained by the financial institution. It is anticipated that the Secretary may determine that certain short-term obligations pose a low risk of U.S. tax evasion and may exclude such debt for these purposes.

A United States owned foreign entity is any foreign entity that has one or more substantial United States owners. A foreign entity is any entity that is not a U.S. person.

A foreign financial institution is any financial institution that is a foreign entity, and except as provided by the Secretary, does not include a financial institution organized under the laws of any possession of the United States. The Secretary may exercise its authority to issue guidance that it deems necessary to prevent financial institutions organized under the laws of U.S. possessions from being used as intermediaries in arrangements under which U.S. tax avoidance or evasion is facilitated.

Except as otherwise provided by the Secretary, a financial institution for these purposes is (1) any entity that accepts deposits in the ordinary course of a banking or similar business, (2) any entity that is engaged in the business of holding financial assets for the account of others, and (3) any entity engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities,[344] interests in partnerships, commodities,[345] or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities. Accordingly, the term financial institution may include among other entities, investment vehicles such as hedge funds and private equity funds. Additionally, the Secretary may provide exceptions for certain classes of institutions. Such exceptions may

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[344] As defined in section 475(c)(2), without regard to the last sentence thereof.

[345] As defined in section 475(e)(2).

include entities such as certain holding companies, research and development subsidiaries, or financing subsidiaries within an affiliated group of non-financial operating companies. It is anticipated that the Secretary may prescribe special rules addressing the circumstances in which certain categories of companies, such as insurance companies, are financial institutions, or the circumstances in which certain accounts or policies, such as policies written by insurance companies, are financial accounts or United States accounts for these purposes.

For purposes of this provision, a recalcitrant account holder is any account holder that: (1) fails to comply with reasonable requests for information necessary to determine if the account is a United States account; (2) fails to provide the name, address, and TIN of each specified United States person and each substantial United States owner of a United States owned foreign entity; or (3) fails to provide a waiver of any foreign law that would prevent the foreign financial institution from reporting any information required under this provision.

A passthru payment is any withholdable payment or other payment that is attributable to a withholdable payment.

The reporting requirements apply with respect to United States accounts maintained by a foreign financial institution and, except as otherwise provided by the Secretary, with respect to United States accounts maintained by each other foreign financial institution that is a member of the same expanded affiliated group as such foreign financial institution. An expanded affiliated group for these purposes is an affiliated group as defined in section 1504(a) except that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in that section, and is determined without regard to paragraphs (2) and (3) of section 1504(b). A partnership or any other entity that is not a corporation is treated as a member of an expanded affiliated group if such entity is controlled by members of such group.[346]

This provision does not apply with respect to a payment if the beneficial owner of such payment is (1) a foreign government, a political subdivision of a foreign government, or a wholly owned agency of any foreign government or political subdivision; (2) an international organization or any wholly owned agency or instrumentality thereof; (3) a foreign central bank of issue; or (4) any other class of persons identified by the Secretary as posing a low risk of U.S. tax evasion.

Under the provision, a withholding agent includes any person, in whatever capacity, having the control, receipt, custody, disposal, or payment of any withholdable payment.

Except as provided by the Secretary, a withholdable payment is any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the United States. The term also includes any gross proceeds from the sale or other disposition of any property that could produce interest or dividends from sources within the United States, including dividend equivalent payments treated as dividends from sources in the United States pursuant to section 541 of the Act. Any item of

[346] Control for these purposes has the same meaning as control for purposes of section 954(d)(3).

income effectively connected with the conduct of a trade or business within the United States that is taken into account under sections 871(b)(1) or 882(a)(2) is not treated as a withholdable payment for purposes of the provision. In determining the source of a payment, section 861(a)(1)(B) (the rule for sourcing interest paid by foreign branches of domestic financial institutions) does not apply.

A substantial United States owner is: (1) with respect to any corporation, any specified U.S. person that directly or indirectly owns more than 10 percent of the stock (by vote or value) of such corporation; (2) with respect to any partnership, a specified United States person that directly or indirectly owns more than 10 percent of the profits or capital interests of such partnership; and (3) with respect to any trust, any specified United States person treated as an owner of any portion of such trust under the grantor trust rules,[347] or to the extent provided by the Secretary, any specified United States person that holds, directly or indirectly, more than 10 percent of the beneficial interests of the trust. To the extent the foreign entity is a corporation or partnership engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, commodities, or any interest (including a futures or forward contract or option) in such securities, interests or commodities, the 10-percent threshold is reduced to zero percent. In determining whether an entity is a United States owned foreign entity (and whether any person is a substantial United States owner of such entity), only specified United States persons are considered.

Except as otherwise provided by the Secretary, a specified United States person is any U.S. person other than (1) a publicly traded corporation or a member of the same expanded affiliated group as a publicly traded corporation, (2) any tax-exempt organization or individual retirement plan, (3) the United States or a wholly owned agency or instrumentality of the United States, (4) a State, the District of Columbia, any possession of the United States, or a political subdivision or wholly owned agency of a State, the District of Columbia, or a possession of the United States, (5) a bank,[348] (6) a real estate investment trust,[349] (7) a regulated investment company,[350] (8) a common trust fund,[351] and (9) a trust that is exempt from tax under section 664(c)[352] or is described in section 4947(a)(1).[353]

[347] Subpart E of Part I of subchapter J of chapter 1.

[348] As defined in section 581.

[349] As defined in section 856.

[350] As defined in section 851.

[351] As defined in section 584(a).

[352] This includes charitable remainder annuity trusts and charitable remainder unitrusts.

[353] This includes certain charitable trusts not exempt under section 501(a).

Withholdable payments to other foreign entities

The provision requires a withholding agent to deduct and withhold a tax equal to 30 percent of any withholdable payment made to a non-financial foreign entity if the beneficial owner of such payment is a non-financial foreign entity that does not meet specified requirements.

A non-financial foreign entity is any foreign entity that is not a financial institution under the provision. A non-financial foreign entity meets the requirements of the provision (i.e., payments made to such entity will not be subject to the imposition of 30-percent withholding tax) if the payee or the beneficial owner of the payment provides the withholding agent with either a certification that the foreign entity does not have a substantial United States owner, or provides the withholding agent with the name, address, and TIN of each substantial United States owner. Additionally, the withholding agent must not know or have reason to know that the certification or information provided regarding substantial United States owners is incorrect, and the withholding agent must report the name, address, and TIN of each substantial United States owner to the Secretary.

The provision does not apply to any payment beneficially owned by a publicly traded corporation or a member of an expanded affiliated group of a publicly traded corporation (defined as above but without the inclusion of partnerships or other non-corporate entities). Publicly traded corporations (and their affiliates) receiving payments directly from U.S. withholding agents may present a lower risk of U.S. tax evasion than other non-financial foreign entities. The provision also does not apply to any payment beneficially owned by any: (1) entity that is organized under the laws of a possession of the United States and that is wholly owned by one or more bona fide residents of the possession; (2) foreign government, political subdivision of a foreign government, or wholly owned agency or instrumentality of any foreign government or political subdivision of a foreign government; (3) international organization or any wholly owned agency or instrumentality of an international organization; (4) foreign central bank of issue; (5) any other class of persons identified by the Secretary for purposes of the provision; or (6) class of payments identified by the Secretary as posing a low risk of U.S. tax evasion. It is anticipated that the Secretary may exclude certain payments made for goods, services, or the use of property if the payment is made pursuant to an arm's length transaction in the ordinary course of the payor's trade or business.

It is expected that the Secretary will provide coordinating rules for application of the withholding provisions applicable to foreign financial institutions and to foreign entities that are non-financial foreign entities under this provision.

Credits and refunds

In general, the determination of whether an overpayment of tax deducted and withheld under the provision results in an overpayment by the beneficial owner of the payment is made in the same manner as if the tax had been deducted and withheld under subchapter A of chapter 3 (withholding tax on nonresident aliens and foreign corporations). An amount of tax required to be withheld by a foreign financial institution under its agreement with the Secretary is treated the same as if it were required to be withheld on a withholdable payment made to a foreign financial institution that does not enter into an agreement with the Secretary. Under the provision, if a beneficial owner of a payment is entitled under an income tax treaty to a reduced rate of withholding tax on the payment, that beneficial owner may be eligible for a credit or refund of the excess of the amount withheld under the provision over the amount permitted to be withheld under the treaty. Similarly, if a payment is of an amount not otherwise subject to U.S. tax (because, for instance, the payment represents gross proceeds from the sale of stock or is interest eligible for the portfolio interest exemption), the beneficial owner of the payment generally is eligible for a credit or refund of the full amount of the tax withheld.

The Secretary has the authority to provide guidance ensuring that taxpayers claiming credits or refunds of amounts withheld from payments to which the provision applies supply appropriate documentation establishing that they are the beneficial owners of the payments from which tax was withheld, and that, in circumstances in which treaty benefits are being claimed, they are eligible for treaty benefits.

If tax is withheld under this provision, this credit and refund mechanism ensures that the provisions are consistent with U.S. obligations under existing income tax treaties. U.S. income tax treaties do not require the United States and its treaty partners to follow a specific procedure for providing treaty benefits.[354] For example, in cases in which proof of entitlement to treaty benefits is demonstrated in advance of payment, the United States may permit reduced withholding or exemption at the time of payment. Alternatively, the United States may require withholding at the relevant statutory rate at the time of payment and allow treaty country residents to obtain treaty benefits through a refund process. The credit and refund mechanism ensures that residents of treaty partners continue to obtain treaty benefits in the event tax is withheld under the provision.

A special rule applies with respect to any tax properly deducted and withheld from a specified financial institution payment, which is defined as any payment with respect to which a foreign financial institution is the beneficial owner. Credits and refunds with respect to specified

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[354] See, for example, the Commentaries on the OECD Model Tax Convention on Income and on Capital, which make clear that individual countries are free to establish procedures for providing any reduced tax rates agreed to by treaty partners. These procedures can include both relief at source and/or full withholding at domestic rates, followed by a refund. See, e.g., Commentary 26.2 to Article 1.

> A number of Articles of the Convention limit the right of a State to tax income derived from its territory. As noted in paragraph 19 of the Commentary on Article 10 as concerns the taxation of dividends, the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A State can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, subject to possible prior verification of treaty entitlement, or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention.

Ibid. While Commentary 26.2 notes that a refund mechanism is not the preferred approach, the bill establishes such a mechanism for beneficial owners in certain circumstances. This approach serves to address, in part, observed difficulties in identifying U.S. persons who inappropriately seek treaty benefits to which they are not entitled.

financial institution payments generally are not allowed. However, refunds and credits are allowed if, with respect to the payment, the foreign financial institution is entitled to an exemption or a reduced rate of tax by reason of any treaty obligation of the United States. In such a case, the foreign financial institution is entitled to an exemption or a reduced rate of tax only to the extent provided under the treaty. In no event will interest be allowed or paid with respect to any credit or refund of tax properly withheld on a specified financial institution payment.

Additionally, no credit or refund is allowed with respect to tax properly deducted and withheld unless the beneficial owner of the payment provides the Secretary with such information as the Secretary may require to determine whether the beneficial owner of the payment is a United States owned foreign entity and the identity of any substantial United States owners of such entity.

Under the provision, the grace period for which the government is not required to pay interest on an overpayment is increased from 45 days to 180 days for overpayments resulting from excess amounts deducted and withheld under chapters 3 or 4 of the Code. The increased grace period applies to refunds of withheld taxes with respect to (1) returns due after the date of enactment, (2) claims for refund filed after date of enactment and (3) IRS-initiated adjustments if the refunds are paid after the date of enactment. It is anticipated that the Secretary may specify the proper form and information required for a claim for refund under section 6611(e)(2) and may provide that a purported claim that does not include such information is not considered filed.

<u>General provisions</u>

Every person required to deduct and withhold any tax under the provision is liable for such tax and is indemnified against claims and demands of any person for the amount of payments made in accordance with the provision.

No person may use information under the provision except for the purpose of meeting any requirements under the provision or for purposes permitted under section 6103. However, the identity of foreign financial institutions that have entered into an agreement with the Secretary is not treated as return information for purposes of section 6103.

The Secretary is expected to provide for the coordination of withholding under this provision with other withholding provisions of the Code, including providing for the proper crediting of amounts deducted and withheld under this provision against amounts required to be deducted and withheld under other provisions of the Code. The Secretary may provide further coordinating rules to prevent double withholding, including in situations involving tiered U.S. withholding agents.

The provision makes several conforming amendments to other provisions in the Code. The provision grants authority to the Secretary to prescribe regulations necessary and appropriate to carry out the purposes of the provision.

Effective Date

The provision generally applies to payments made after December 31, 2012. The provision, however, does not require any amount to be deducted or withheld from any payment under any obligation outstanding on the date that is two years after the date of enactment. It is anticipated that the Secretary may provide guidance as to the application of the material modification rules under section 1001 in determining whether an obligation is considered to be outstanding on the date that is two years after the date of enactment.

The interest provisions increasing the grace period for which the government is not required to pay interest on an overpayment from 45 to 180 days apply to: (1) returns with due dates after the date of enactment; (2) claims for credit or refund of overpayment filed after the date of enactment; and (3) refunds paid on adjustments initiated by the Secretary paid after the date of enactment.

2. Repeal of certain foreign exceptions to registered bond requirements (sec. 502 of the bill and secs. 163, 165, 871, 881, 1287, and 4701 of the Code and 31 U.S.C. sec. 3121)

Present Law

Registration-required obligations and treatment of bonds not issued in registered form

In general, a taxpayer may deduct all interest paid or accrued within the taxable year on indebtedness.[355] For registration-required obligations, a deduction for interest is allowed only if the obligation is in registered form. Generally, an obligation is treated as issued in registered form if the issuer or its agent maintains a registration of the identity of the owner of the obligation and the obligation can be transferred only through this registration system.[356] A registration-required obligation is any obligation other than one that: (1) is made by a natural person; (2) matures in one year or less; (3) is not of a type offered to the public; or (4) is a foreign targeted obligation.[357]

In applying this requirement, the IRS has adopted a flexible approach that recognizes that a debt obligation that is formally in bearer (i.e., not in registered) form is nonetheless "in

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[355] Sec. 163(a).

[356] An obligation is treated as in registered form if (1) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, (2) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent, or (3) the obligation is registered as to both principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Treas. Reg. sec. 5f.103-1(c).

[357] Sec. 163(f)(2)(A). The registration requirement is intended to preserve liquidity while reducing opportunities for noncompliant taxpayers to conceal income and property from the reach of the income, estate and gift taxes. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, p. 190.

registered form" for these purposes where there are arrangements that preclude individual investors from obtaining definitive bearer securities or that permit such securities to be issued only upon the occurrence of an extraordinary event.[358]

A foreign targeted obligation (to which the registration requirement does not apply) is any obligation satisfying the following requirements: (1) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person; (2) interest is payable only outside the United States and its possessions; and (3) the face of the obligation contains a statement that any United States person who holds this obligation will be subject to limitations under the U.S. income tax laws.[359]

In addition to the denial of an interest deduction, an excise tax is imposed on the issuer of any registration-required obligation that is not in registered form.[360] The excise tax is equal to one percent of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) during the period beginning on the date of issuance of the obligation and ending on the date of maturity.

Moreover, any gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation is treated as ordinary income (rather than capital gain), unless the issuer of the obligation was subject to the excise tax described above.[361] Finally, deductions for losses realized by beneficial owners of registration-required obligations that are not in a registered form are disallowed.[362] For the purposes of ordinary income treatment and denial of deduction for losses,a registration-required obligation is any obligation other than one that: (1) is made by a natural person; (2) matures in one year or less; or (3) is not of a type offered to the public.

Treatment as portfolio interest

Payments of U.S.-source "fixed or determinable annual or periodical" income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a

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[358] Priv. Ltr. Rul. 1993-43-018 (1993); Priv. Ltr. Rul. 1993-43-019 (1993); Priv. Ltr. Rul. 1996-13-002 (1996). The IRS held that the registration requirement may be satisfied by "dematerialized book-entry systems" developed in some foreign countries, even if, under such a system, a holder is entitled to receive a physical certificate, tradable as a bearer instrument, in the event the clearing organization maintaining the system goes out of existence, because "cessation of operation of the book-entry system would be an extraordinary event." Notice 2006-99, 2006-2 C.B. 907.

[359] Sec. 163(f)(2)(B).

[360] Sec. 4701.

[361] Sec. 1287.

[362] Sec. 165(j).

reduced rate of withholding under an income tax treaty.[363] In 1984, the Congress repealed the 30-percent tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States.[364]

The term "portfolio interest" means any interest (including original issue discount) that is (1) paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person, or (2) paid on an obligation that is not in registered form and that meets the foreign targeting requirements of section 163(f)(2)(B).[365] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[366] certain contingent interest,[367] interest received by a controlled foreign corporation from a related person,[368] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[369]

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[363] Secs. 871, 881; Treas. Reg. sec. 1.1441-1(b). Generally, the determination by a withholding agent of the U.S. or foreign status of a payee and of its other relevant characteristics (e.g., as a beneficial owner or intermediary, or as an individual, corporation, or flow-through entity) is made on the basis of a withholding certificate that is a Form W-8 or a Form 8233 (indicating foreign status of the payee or beneficial owner) or a Form W-9 (indicating U.S. status of the payee).

[364] Secs. 871(h) and 881(c). Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market (i.e., the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the U.S. Treasury Department direct access to the Eurobond market. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

[365] In repealing the 30-percent tax on portfolio interest, under the Deficit Reduction Act of 1984, Congress expressed concern about potential compliance problems in connection with obligations issued in bearer form. Given the foreign targeted exception to the registration requirement under section 163(f)(2)(A), U.S. persons intent on evading U.S. tax on interest income might attempt to buy U.S. bearer obligations overseas, claiming to be foreign persons. These persons might then claim the statutory exemption from withholding tax for the interest paid on the obligations and fail to declare the interest income on their U.S. tax returns, without concern that their ownership of the obligations would come to the attention of the IRS. Because of these concerns, Congress expanded the Treasury's authority to require registration of obligations deigned to be sold to foreign persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 393.

[366] Sec. 871(h)(3).

[367] Sec. 871(h)(4).

[368] Sec. 881(c)(3)(C).

[369] Sec. 881(c)(3)(A).

Requirement that U.S. Treasury obligations be in registered form

Under title 31 of the United States Code, every "registration-required obligation" of the U.S. Treasury must be in registered form.[370] For this purpose, a foreign targeted obligation is excluded from the definition of a registration-required obligation.[371] Thus, a foreign targeted obligation of the Treasury can be in bearer (rather than registered) form.

Explanation of Provision

Repeal of the foreign targeted obligation exception to the registration requirement

The provision repeals the foreign targeted obligation exception to the denial of a deduction for interest on bonds not issued in registered form. Thus, under the provision, a deduction for interest is disallowed with respect to any obligation not issued in registered form, unless that obligation (1) is issued by a natural person, (2) matures in one year or less, or (3) is not of a type offered to the public.

The bill preserves the ordinary income treatment under present law of any gain realized by the beneficial owner from the sale or other disposition of a registration-required obligation that is not in registered form. Similarly, the bill does not change the present law rule disallowing deductions for losses realized by a beneficial owner of a registration-required obligation that is not in a registered form.

Preservation of exception to the registration requirement for excise tax purposes

Under the provision, the foreign targeted obligation exception is available with respect to the excise tax applicable to issuers of registration-required obligations that are not in registered form. Thus, the excise tax applies with respect to any obligation that is not in registered form unless the obligation (1) is issued by a natural person, (2) matures in one year or less, (3) is not of a type offered to the public, or (4) is a foreign targeted obligation.

Repeal of treatment as portfolio interest

The provision repeals the treatment as portfolio interest of interest paid on bonds that are not issued in registered form but meet the foreign targeting requirements of section 163(f)(2)(B). Under the provision, interest qualifies as portfolio interest only if it is paid on an obligation that is issued in registered form and either (1) the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a United States person (on IRS Form W-8), or (2) the Secretary has determined that such statement is not required in order to carry out the purposes of the subsection. It is anticipated that the Secretary may exercise its authority under this rule to waive the requirement of collecting Forms W-8 in circumstances in

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[370] 31 U.S.C. sec. 3121(g)(3). For purposes of title 31 of the United States Code, registration-required obligation is defined as any obligation except: (1) an obligation not of a type offered to the public; (2) an obligation having a maturity (at issue) of not more than one year; or (3) a foreign targeted obligation.

[371] 31 U.S.C. sec. 3121(g)(2).

which the Secretary has determined there is a low risk of tax evasion and there are adequate documentation standards within the country of tax residency of the beneficial owner of the obligations in question. Generally, however, as a result of the provision, interest paid to a foreign person on an obligation that is not issued in registered form is subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding other than the portfolio interest exemption or for a reduced rate of withholding under an income tax treaty.

Dematerialized book-entry systems treated as registered form

The provision provides that a debt obligation held through a dematerialized book entry system is treated, for purposes of section 163(f), as held through a book entry system for the purpose of treating the obligation as in registered form.[372] A debt obligation that is formally in bearer form is treated, for the purposes of section 163(f), as held in a book-entry system as long as the debt obligation may be transferred only by book entries and the holder of the obligation does not have the ability to withdraw the obligation from the book-entry system and obtain a physical certificate in bearer form in the ordinary course of business.[373]

Repeal of exception to requirement that Treasury obligations be in registered form

The provision includes a conforming change to title 31 of the United States Code that repeals the foreign targeted exception to the definition of a registration-required obligation. Thus, a foreign targeted obligation of the Treasury must be in registered form.

Effective Date

The provision applies to debt obligations issued after the date which is two years after the date of enactment.

[372] By reason of cross references, this rule will also apply to sections 165(j), 312(m), 871(h), 881(c), 1287 and 4701.

[373] The issuance of physical certificates in bearer form in the event that the book entry system goes out of existence would be an extraordinary event that is not in the ordinary course of business. Notice 2006-99, 2006-2 C.B. 907.

B. Under Reporting With Respect to Foreign Assets

1. Disclosure of information with respect to foreign financial assets (sec. 511 of the bill and new sec. 6038D of the Code)

Present Law

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both Title 26 (the Internal Revenue Code) and Title 31 (the Bank Secrecy Act) of the United States Code.

Since its enactment, the Bank Secrecy Act has been expanded beyond its original focus on large currency transactions, while retaining its broad purpose of obtaining self-reporting of information with "a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings."[374] As the reporting regime has expanded,[375] reporting obligations have been imposed on both financial institutions and account holders. With respect to account holders, a U.S. citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary, when that person enters into a transaction or maintains an account with a foreign financial agency.[376] Regulations promulgated pursuant to broad regulatory authority granted to the Secretary in the Bank Secrecy Act[377] provide additional guidance regarding the disclosure obligation with respect to foreign accounts. The Bank Secrecy Act specifies only that such disclosure contain the following information "in the way and to the extent the Secretary prescribes": (1) the identity and address of participants in a transaction or relationship; (2) the legal capacity in which a participant is acting; (3) the identity of real parties in interest; and (4) a description of the transaction.

Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," (the "FBAR") must be filed by June 30 of the year following the year in which the $10,000 filing threshold is met.[378] The FBAR is filed with the Treasury Department at the IRS

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[374] 31 U.S.C. sec. 5311.

[375] See e.g., Title III of the USA PATRIOT Act, Pub. L. No. 107-56 (October 26, 2001) (sections 351 through 366 amended the Bank Secrecy Act as part of a series of reforms directed at international financing of terrorism).

[376] 31 U.S.C. sec. 5314. The term "agency" in the Bank Secrecy Act includes financial institutions.

[377] 31 U.S.C. sec. 5314(a) provides: "Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency."

[378] 31 C.F.R. sec. 103.27(c). The $10,000 threshold is the aggregate value of all foreign financial accounts in which a U.S. person has a financial interest or over which the U.S. person has signature or other authority.

Detroit Computing Center. Failure to file the FBAR is subject to both criminal[379] and civil penalties.[380] Since 2004, the civil sanctions have included penalties not to exceed (1) $10,000 for failures that are not willful and (2) the greater of $100,000 or 50 percent of the balance in the account for willful failures. Although the FBAR is received and processed by the IRS, it is neither part of the income tax return filed with the IRS nor filed in the same office as that return. As a result, for purposes of Title 26, the FBAR is not considered "return information," and its distribution to other law enforcement agencies is not limited by the nondisclosure rules of Title 26.[381]

Although the obligation to file an FBAR arises under Title 31, individual taxpayers subject to the FBAR reporting requirements are alerted to this requirement in the preparation of annual Federal income tax returns. Part III ("Foreign Accounts and Trusts") of Schedule B of the 2008 IRS Form 1040 includes the question, "At any time during 2008, did you have an interest in or signatory or any other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?" and directs taxpayers to "See page B-2 for exceptions and filing requirements for Form TD F 90-22.1." The Form 1040 instructions advise individuals who answer "yes" to this question to identify the foreign country or countries in which such accounts are located.[382] Responding to this question does not discharge one's obligations under Title 31 and constitutes "return information" protected from routine disclosure to those charged with enforcing Title 31. In addition, the Form 1040 instructions identify certain types of accounts that are not subject to disclosure, including those instances in which the combined value of all accounts held by the taxpayer did not exceed $10,000 at any point during the relevant tax year.

The FBAR requires disclosure of any account in which the filer has a financial interest or as to which the filer has signature or other authority (in which case the filer must identify the owner of the account). The Treasury Department and the IRS revised the FBAR and its accompanying instructions in October, 2008, to clarify the filing requirements for U.S. persons holding interests in foreign bank accounts.[383] For example, the terminology has been updated to

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[379] 31 U.S.C. sec. 5322 (failure to file is punishable by a fine up to $250,000 and imprisonment for five years, which may double if the violation occurs in conjunction with certain other violations).

[380] 31 U.S.C. sec. 5321(a)(5).

[381] Section 6103 bars disclosure of return information, unless permitted by an exception.

[382] 31 C.F.R. sec. 103.24.

[383] Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, and its instructions states:

> A financial interest in a bank, securities, or other financial account in a foreign country means an interest described in one of the following three paragraphs: 1. A United States person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non–United States persons. 2. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent,

reflect new types of financial transactions. For example, "financial account" now specifies that debit or prepaid credit cards are financial accounts,[384] and the definition of "signature or other authority" now encompasses the ability to indirectly exercise this authority, even in the absence of written instructions.[385] The revised instructions also provide that foreign individuals doing business in the United States may be required to file an FBAR.[386] In August, 2009, the IRS requested public comments to help determine the scope and nature of future additional guidance.[387]

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nominee, attorney, or in some other capacity on behalf of the U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power for all shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income, taking into account any special allocation agreement) or more than 50 percent of the capital of the partnership; or (d) a trust in which the United States person either has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income. 3. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed. A trust protector is a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee. Correspondent or "nostro" accounts (international interbank transfer accounts) maintained by banks that are used solely for the purpose of bank-to-bank settlement need not be reported on this form, but are subject to other Bank Secrecy Act filing requirements. This exception is intended to encompass those accounts utilized for bank-to-bank settlement purposes only.

[384] See Chief Counsel Advice 200603026 (January 20, 2006) for a discussion of whether payment card accounts constitute financial accounts.

[385] According to the instructions to the FBAR, a person has "signature authority" over an account "if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is maintained." "Other authority" exists in a person "who can exercise comparable power over an account by communication to the bank or other person with whom the account is maintained, either directly or through an agent, nominee, attorney, or in some other capacity on behalf of the US person, either orally or by some other means."

[386] Although the revised instructions currently track the language of the statute in stating that a person in or doing business in the United States is within its purview, and thus merely clarify what has long been required, the IRS announced that pending publication of guidance on the scope of the statute, people could rely on the earlier, unrevised instructions to determine whether they are required to file a FBAR. Announcement 2009-51, 2009-25 I.R.B. 1105. Subsequently, the IRS announced that persons with only signature authority over a foreign financial account as well as for signatories or owners of financial interest in a foreign commingled fund have until June 30, 2010 to file an FBAR for the 2008 and earlier calendar years with respect to those accounts. Notice 2009-62, 2009-35 I.R.B. 260.

[387] Notice 2009-62, 2009-35 I.R.B. 260, specifically requested comments concerning: (1) when a person having only signature authority or having an interest in a commingled fund should be relieved of filing an FBAR; (2) the circumstances under which the FBAR filing exceptions for officers and employees of banks and some publicly traded domestic corporations should be expanded; (3) when an interest in a foreign entity should be subject

The revised instructions explain the basis for reporting other information in more detail, and provide that (1) all foreign persons with an interest in the account must be identified (including foreign identification numbers for each), (2) the highest value held in the account at any point in the year must be disclosed, (3) corporate employees with signature authority but no financial interest are generally required to disclose the signature authority, unless the corporate Chief Financial Officer ("CFO") (or in the case of an employee of a subsidiary, the parent company's CFO) certifies that the account will be reported on the corporate filing and (4) any amended or delinquent filing should be identified as such, and accompanied by an explanatory statement.

In addition to the FBAR requirements under Title 31, there are additional reports required by the Code to be filed with the IRS by U.S. persons engaged in foreign activities, directly or indirectly, through a foreign business entity. Upon the formation, acquisition or ongoing ownership of certain foreign corporations, U.S. persons that are officers, directors, or shareholders must file a Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations."[388] Similarly, an IRS Form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships," must be filed with respect to certain interests in a controlled foreign partnership; an IRS Form 3520, "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts," must be filed with respect to certain foreign trusts; and an IRS Form 8858, "Information Return of U.S. Persons With Respect To Foreign Disregarded Entities" must be filed with respect to a foreign disregarded entity.[389] To the extent that the U.S. person engages in such foreign activities indirectly through a foreign business entity, other self-reporting requirements may apply. In addition, a U.S. person that capitalizes a foreign entity generally is required to file an IRS Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."[390]

With the exception of the questions included on Form 1040, Schedule B, there is no requirement to disclose the information includible on FBAR on an individual tax return.

<u>FBAR enforcement responsibility</u>

Until 2003, the Financial Crimes and Enforcement Network ("FinCEN"), an agency of the Department of the Treasury, had responsibility for civil penalty enforcement of FBAR. In 2003, the authority to investigate FBAR compliance was delegated to the IRS Criminal

to FBAR reporting; and (4) whether the passive asset and passive income thresholds are appropriate and should apply conjunctively.

[388] Secs. 6038, 6046.

[389] Form 8858 is used to satisfy reporting requirements of sections 6011, 6012, 6031, 6038, and related regulations.

[390] Sec. 6038B. The filing of this form may also be required upon future contributions to the foreign corporation.

Investigation Division.[391] As a result, persons who were more than 180 days delinquent in paying any FBAR penalties were referred for collection action to the Financial Management Service of the Treasury Department, which is responsible for such non-tax collections.[392] Continued nonpayment resulted in a referral to the Department of Justice for institution of court proceedings against the delinquent person. In 2003, the Secretary delegated civil enforcement to the IRS.[393] This change reflected the fact that a major purpose of the FBAR was to identify potential tax evasion, and therefore was not closely aligned with FinCEN's core mission.[394] The authority delegated to the IRS in 2003 included the authority to determine and enforce civil penalties,[395] as well as to revise the form and instructions. However, the collection and enforcement powers available to enforce the Internal Revenue Code under Title 26 are not available to the IRS in the enforcement of FBAR civil penalties, which remain collectible only in accord with the procedures for non-tax collections described above.

In general, information reported on an FBAR is available to the IRS and other law enforcement agencies. In contrast, information on income tax returns–including the Schedule B information regarding foreign bank accounts–is not readily available to those within the IRS who are charged with administering FBAR compliance, despite the fact that Federal returns and return information may be the best source of information for this purpose.

The nondisclosure constraints on IRS personnel who examine income tax liability (i.e., Form 1040 reporting) generally preclude the sharing of tax return information with any other IRS personnel or Treasury officials, except for tax administration purposes.[396] Tax administration is defined as "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes" and does not necessarily include administration of Title 31.[397] Because Title 31 includes enforcement of non-tax provisions of the

[391] Treas. Directive 15-14 (December 1, 1992), in which the Secretary delegated to the IRS authority to investigate violations of the Bank Secrecy Act. If the IRS Criminal Investigation Division declines to pursue a possible criminal case, it is to refer the matter to FinCEN for civil enforcement.

[392] 31 U.S.C. sec. 3711(g).

[393] 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003); News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003).

[394] Secretary of the Treasury, "A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 24, 2003).

[395] A penalty may be assessed before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed. 31 U.S.C. sec. 5321(b)(1). A civil action for collection may be commenced within two years of the later of the date of assessment and the date a judgment becomes final in any a related criminal action. 31 U.S.C. sec. 5321(b)(2).

[396] Sec. 6103(h)(1). In essence, section 6103(h)(1) authorizes officers and employees of both the Treasury Department and IRS to have access to return information on the basis of a "need to know" in order to perform a tax administration function.

[397] Sec. 6103(b)(4).

Bank Secrecy Act, Title 31 is not, per se, a "related statute," for purposes of finding that a disclosure of such information would be for tax administration purposes. As a result, IRS personnel charged with investigating and enforcing the civil penalties under Title 31 are not routinely permitted access to Form 1040 information that would support or shed light on the existence of an FBAR violation. Instead, there must be a determination, in writing, that the FBAR violation was in furtherance of a Title 26 violation in order to support a finding that the statutes are "related statutes" for purposes of authorizing the disclosure. The effect of this prerequisite is to subsume the bank account information reported on Form 1040 under the scope of "return information" and therefore, the protection from disclosure provided under Title 26.[398]

Penalties

Failure to comply with the FBAR filing requirements is subject to penalties imposed under Title 31 of the United States Code, and may be both civil and criminal. Since the initial enactment of the Bank Secrecy Act, a willful failure to comply with the FBAR reporting requirement has been subject to a civil penalty. In 2004, the available penalties were expanded to include a reduced penalty for a non-willful failure to file.[399] Willful failure to file an FBAR may be subject to penalties in amounts not to exceed the greater of $100,000 or 50 percent of the amount in the account at the time of the violation.[400] A non-willful, but negligent, failure to file is subject to a penalty of $10,000 for each negligent violation.[401] The penalty may be waived if (1) there is reasonable cause for the failure to report and (2) the amount of the transaction or balance in the account was properly reported. In addition, serious violations are subject to criminal prosecution, potentially resulting in both monetary penalties and imprisonment. Civil and criminal sanctions are not mutually exclusive.

Failure to comply with information returns required by the Internal Revenue Code is subject to a variety of sanctions, including (1) suspension of the applicable statute of limitations,[402] (2) disallowance of otherwise permitted tax attributes, deductions or credits,[403] and (3) imposition of penalties. For most information returns, the failure to file penalty is $50 per return, up to a maximum of $250,000 per taxpayer.[404] Failures to disclose control of any foreign business entity,[405] foreign parties with 25 percent ownership interest in a domestic company, [406]

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398 Internal Revenue Manual, paragraphs 4.26.14.2 and 4.26.14.2.1.

399 American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 821(b), 118 Stat. 1418. This provision is codified in 31 U.S.C. sec. 5321(a)(5).

400 31 U.S.C. sec. 5321(a)(5)(C).

401 31 U.S.C. sec. 5321(a)(5)(B)(i), (ii).

402 Sec. 6501(c)(8).

403 Secs. 1295, 6038.

404 Sec. 6721.

405 Sec. 6038.

406 Sec. 6038A.

domestic officers and 10 percent owners of a foreign corporation,[407] or change in ownership of a foreign partnership[408] are subject to penalties of $10,000, plus $10,000 for every 30 days the failure to file persists longer than 90 days after the taxpayer is informed of the failure. A failure to report a transfer to a foreign corporation is subject to a penalty equal to 10 percent of the value of the transfer, but is capped at $10,000 if the failure is not willful.[409] Failure to report the creation of a foreign trust is subject to a 35 percent penalty on the reportable amount (or five percent for a Form 3520-A report), plus $10,000 for every 30 days the failure to file persists after 90 days from the date on which the taxpayer is informed of the failure to file. The penalty is capped at the gross reportable amount.[410]

Explanation of Provision

The provision requires individual taxpayers with an interest in a "specified foreign financial asset" during the taxable year to attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than $50,000. Although the nature of the information required is similar to the information disclosed on an FBAR, it is not identical. For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value threshold is met. Nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision.

"Specified foreign financial assets" are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, (1) stocks or securities issued by foreign persons, (2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (3) any interest in a foreign entity. The information to be included on the statement includes identifying information for each asset and its maximum value during the taxable year. For an account, the name and address of the institution at which the account is maintained and the account number are required. For a stock or security, the name and address of the issuer, and any other information necessary to identify the stock or security and terms of its issuance must be provided. For all other instruments or contracts, or interests in foreign entities, the information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counterparties. An individual is not required under this provision to disclose interests under that are held in a custodial account with a U.S. financial institution nor is an individual required to identify separately any stock, security instrument, contract, or interest in a foreign financial account disclosed under the provision. In addition, the provision permits the Secretary to issue regulations that would apply the reporting

[407] Sec. 6046.

[408] Sec. 6046A.

[409] Sec. 6038B.

[410] Sec. 6048.

obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly.

Individuals who fail to make the required disclosures are subject to a penalty of $10,000 for the taxable year. An additional penalty may apply if the Secretary notifies an individual by mail of the failure to disclose and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by $10,000 for each 30 day period (or a fraction thereof), up to a maximum penalty of $50,000 for one taxable period. The computation of the penalty is similar to that applicable to failures to file reports with respect to certain foreign corporations under section 6038. Thus, an individual who is notified of his failure to disclose with respect to a single taxable year under this provision and who takes remedial action on the 95th day after such notice is mailed incurs a penalty of $20,000 comprising the base amount of $10,000, plus $10,000 for the fraction (i.e., the five days) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed. An individual who postpones remedial action until the 181st day is subject to the maximum penalty of $50,000: the base amount of $10,000, plus $30,000 for the three 30-day periods, plus $10,000 for the one fraction (i.e., the single day) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed.

No penalty is imposed under the provision against an individual who can establish that the failure was due to reasonable cause and not willful neglect. Foreign law prohibitions against disclosure of the required information cannot be relied upon to establish reasonable cause.

To the extent the Secretary determines that the individual has an interest in one or more foreign financial assets but the individual does not provide enough information to enable the Secretary to determine the aggregate value thereof, the aggregate value of such identified foreign financial assets will be presumed to have exceeded $50,000 for purposes of assessing the penalty.

The provision also grants authority to promulgate regulations necessary to carry out the intent. Such regulations may include exceptions for nonresident aliens and classes of assets identified by the Secretary, including those assets which the Secretary determines are subject to reporting requirements under other provisions of the Code. In particular, regulatory exceptions to avoid duplicative reporting requirements are anticipated.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

2. Penalties for underpayments attributable to undisclosed foreign financial assets (sec. 512 of the bill and sec. 6662 of the Code)

Present Law

The Code imposes penalties equal to 20 percent of the portion of any underpayments that are attributable to any of the following five grounds: (1) negligence or disregard of rules or regulations; (2) any substantial understatement[411] of income tax; (3) any substantial valuation misstatement; (4) any substantial overstatement of pension liabilities; and (5) any substantial estate or gift tax valuation understatement. With the exception of a penalty based on negligence or disregard of rules or regulations, these penalties are commonly referred to as accuracy-related penalties, because the imposition of the penalty does not require an inquiry into the culpability of the taxpayer. If the penalty is asserted, a taxpayer may defend against the penalty by demonstrating that (1) there was "reasonable cause" for the underpayment and (2) the taxpayer acted in good faith.[412] Regulations provide that reasonable cause exists in cases in which the taxpayer "reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[413]

A penalty for a substantial understatement may be reduced to the extent of the portion of the understatement attributable to an item on the return for which the challenged tax treatment (1) is supported by substantial authority or (2) is adequately disclosed on the return and there was a reasonable basis for such treatment. The tax treatment is considered to have been adequately disclosed only if all relevant facts are disclosed with the return. Regardless of whether an item would otherwise meet either of these tests, this defense is not available with respect to penalties imposed on understatements arising from tax shelters.[414] The Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

Under present law, failure to comply with the various information reporting requirements generally does not, in itself, determine the amount of the penalty imposed on an underpayment of tax. However, such failure to comply may be relevant to (1) establishing negligence under section 6662 or fraudulent intent,[415] (2) determining whether penalties based on culpability are applicable or (3) determining whether certain defenses are available.

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[411] If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (1) 10 percent of the correct tax (or, if greater, $10,000) or (2) $10 million), then a substantial understatement exists.

[412] Sec. 6664(c).

[413] Treas. Reg. secs. 1.6662-4(g)(4)(i)(B), 1.6664-4(c).

[414] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

[415] Section 6663 imposes a penalty of 75 percent on that portion of the understatement attributable to fraud. If the government proves that such understatement was attributable to fraud, there is a rebuttable presumption that any other understatement is attributable to fraud.

In the context of transactions that are subject to the “reportable transaction” disclosure regime,[416] a separate accuracy-related penalty may apply.[417] That penalty applies to “listed transactions” and other “reportable transactions” that have a significant tax avoidance purpose (a “reportable avoidance transaction”). The penalty rate and defenses available to avoid the section 6662A penalty vary, based on the adequacy of disclosure. In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[418] An exception is available if the taxpayer satisfies a higher standard under the reasonable cause and good faith exception. This higher standard requires the taxpayer to demonstrate that there was (1) adequate disclosure of the relevant facts affecting the treatment on the taxpayer’s return, (2) substantial authority for the treatment on the taxpayer’s return, and (3) a reasonable belief that the treatment on the taxpayer’s return was more likely than not the proper treatment.[419] If the transaction is not adequately disclosed, the reasonable cause exception is not available and the taxpayer is subject to a penalty equal to 30 percent of the understatement.[420]

Explanation of Provision

The provision adds a new accuracy related penalty to section 6662. The new provision, which is subject to the same defenses as are otherwise available under section 6662, imposes a 40-percent penalty on any understatement attributable to an undisclosed foreign financial asset. The term “undisclosed foreign financial asset” includes all assets subject to certain information reporting requirements[421] for which the required information was not provided by the taxpayer as required under the applicable reporting provisions. An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving such asset. Thus, a U.S. person who fails to comply with the various self-reporting requirements for a foreign financial asset and engages in a transaction with respect to that asset incurs a penalty on any resulting underpayment that is double the otherwise applicable penalty for substantial understatements or negligence. For example, if a taxpayer fails to disclose amounts held in a foreign financial account, any underpayment of tax related to the transaction that gave rise to the income would be subject to the penalty provision, as would any underpayment related to interest, dividends or other returns accrued on such undisclosed amounts.

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[416] Secs. 6011 through 6112 require taxpayers and their advisers to disclose certain transactions determined to have the potential for tax avoidance. All such transactions are referred to as “reportable transactions,” and include within that class of transactions, those that are “listed,” that is, the subject of published guidance in which the Secretary announces his intent to challenge such transactions.

[417] Sec. 6662A.

[418] Sec. 6662A(a).

[419] Sec. 6664(d).

[420] Sec. 6662A(c).

[421] The information reporting requirements identified include sections 6038, 6038A, new 6038D, 6046A, and 6048.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

3. Modification of statute of limitations for significant omission of income in connection with foreign assets (sec. 513 of the bill and secs. 6229 and 6501 of the Code)

Present Law

Taxes are generally required to be assessed within three years after a taxpayer's return was filed, whether or not it was timely filed.[422] Of the exceptions to this general rule, only section 6501(c)(8) is specifically targeted at the identification of, and collection of information about, cross-border transactions. Under this exception, the limitation period for assessment of any tax imposed under the Code with respect to any event or period to which information about certain cross-border transactions required to be reported relates does not expire any earlier than three years after the required information is actually provided to the Secretary by the person required to file the return.[423] In general, such information reporting is due with the taxpayer's return; thus, the three-year limitation period commences when a timely and complete (including all information reporting) return is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are subsequently provided to the Secretary, even though the return has been filed.

In the case of a false or fraudulent return filed with the intent to evade tax, or if the taxpayer fails to file a required return, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.[424] The limitation period also may be extended by taxpayer consent.[425] If a taxpayer engages in a listed transaction but fails to include any of the information required under section 6011 on any return or statement for a taxable year, the limitation period with respect to such transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is provided the information so required, or (2) the date that a "material advisor" (as defined in section 6111) makes its section 6112(a) list available for inspection pursuant to a request by the Secretary under section 6112(b)(1)(A).[426]

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[422] Sec. 6501(a). Returns that are filed before the date they are due are deemed filed on the due date. See sec. 6501(b)(1) and (2).

[423] Required information reporting subject to this three-year rule is reporting under sections 6038 (certain foreign corporations and partnerships), 6038A (certain foreign-owned corporations), 6038B (certain transfers to foreign persons), 6046 (organizations, reorganizations, and acquisitions of stock of foreign corporations), 6046A (interests in foreign partnerships), and 6048 (certain foreign trusts).

[424] Sec. 6501(c).

[425] Sec. 6501(c)(4).

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

A special rule is provided where there is a substantial omission of income. If a taxpayer omits substantial income on a return, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed. In the case of income taxes, "substantial" means at least 25 percent of the amount that was properly includible in gross income; for estate and gift taxes, it means 25 percent of a gross estate or total gifts. For this purpose, the gross income of a trade or business means gross receipts, without reduction for the cost of sales or services.[427] An amount is not considered to have been omitted if the item properly includible in income is disclosed on the return.[428]

In addition to the exceptions described, there are also circumstances under which the three-year limitation period is suspended. For example, service of an administrative summons triggers the suspension either (1) beginning six months after service (in the case of John Doe summonses)[429] or (2) when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record-keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

Explanation of Provision

The provision authorizes a new six-year limitations period for assessment of tax on understatements of income attributable to foreign financial assets. The present exception that provides a six-year period for substantial omission of an amount equal to 25 percent of the gross income reported on the return is not changed.

The new exception applies if there is an omission of gross income in excess of $5,000 and the omitted gross income is attributable to an asset with respect to which information reports are required under section 6038D, as applied without regard to the dollar threshold, the statutory exception for nonresident aliens and any exceptions provided by regulation. If a domestic entity is formed or availed of to hold foreign financial assets and is subject to the reporting requirements of section 6038D in the same manner as an individual, the six-year limitations period may also apply to that entity. The Secretary is permitted to assess the resulting deficiency at any time within six years of the filing of the income tax return.

In providing that the applicability of section 6038D information reporting requirements is to be determined without regard to the statutory or regulatory exceptions, the statute ensures that the longer limitation period applies to omissions of income with respect to transactions involving foreign assets owned by individuals. Thus, a regulatory provision that alleviates duplicative reporting obligations by providing that a report that complies with another provision of the Code may satisfy one's obligations under new section 6038D does not change the nature of the asset

[427] Sec. 6501(e)(1)(A)(i).

[428] Sec. 6501(e)(1)(A)(ii) provides that, in determining whether an amount was omitted, any amounts that are disclosed in the return or in a statement attached to the return in a manner adequate to apprise the Secretary of the nature and amount of such item are not taken into account.

[429] Sec. 7609(e)(2).

subject to reporting. The asset remains one that is subject to the requirements of section 6038D for purposes of determining whether the exception to the three-year statute of limitations applies.

The provision also suspends the limitations period for assessment if a taxpayer fails to provide timely information returns required with respect to passive foreign investment corporations[430] and the new self-reporting of foreign financial assets. The limitations period will not begin to run until the information required by those provisions has been furnished to the Secretary. The provision also clarifies that the extension is not limited to adjustments to income related to the information required to be reported by one of the enumerated sections.

Effective Date

The provision applies to returns filed after the date of enactment as well as for any other return for which the assessment period specified in section 6501 has not yet expired as of the date of enactment.

[430] Sec. 1295(b), (f).

C. Other Disclosure Provisions

1. Reporting of activities with respect to passive foreign investment companies (sec. 521 of the bill and sec. 1298 of the Code)

Present Law

In general, active foreign business income derived by a foreign corporation with U.S. owners is not subject to current U.S. taxation until the corporation makes a dividend distribution to those owners. Certain rules, however, restrict the benefit of deferral of U.S. tax on income derived through foreign corporations. One such regime applies to U.S. persons who own stock of passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income.[431] Various sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs under which U.S. shareholders pay tax on certain income or gain realized through the companies, plus an interest charge intended to eliminate the benefit of deferral.[432] A second set of rules applies to PFICs that are "qualified electing funds" ("QEF"), under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[433] A third set of rules applies to marketable PFIC stock, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[434]

In general, a U.S. person that is a direct or indirect shareholder of a PFIC must file IRS Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund" for each tax year in which that U.S. person (1) recognizes gain on a direct or indirect disposition of PFIC stock, (2) receives certain direct or indirect distributions from a PFIC, or (3) is making a reportable election.[435] The Code includes a general reporting

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[431] Sec. 1297.

[432] Sec. 1291.

[433] Secs. 1293-1295.

[434] Sec. 1296.

[435] See Instructions to IRS Form 8621. According to the form, reportable elections include the following: (i) an election to treat the PFIC as a QEF; (ii) an election to recognize gain on the deemed sale of a PFIC interest on the first day of the PFIC's tax year as a QEF; (iii) an election to treat an amount equal to the shareholder's post-1986 earnings and profits of a CFC as an excess distribution on the first day of a PFIC's tax year as a QEF that is also a controlled foreign corporation under section 957(a); (iv) an election to extend the time for payment of the shareholder's tax on the undistributed earnings and profits of a QEF; (v) an election to treat as an excess distribution

requirement for certain PFIC shareholders which is contingent upon the issuance of regulations.[436] Although Treasury issued proposed regulations in 1992 requiring U.S. persons to file annually Form 8621 for each PFIC of which the person is a shareholder during the taxable year, such regulations have not been finalized and current IRS Form 8621 requires reporting only based on one of the triggering events described above.[437]

Explanation of Provision

The provision requires that, unless otherwise provided by the Secretary, each U.S. person who is a shareholder of a PFIC must file an annual information return containing such information as the Secretary may require. A person that meets the reporting requirements of this provision may, however, also meet the reporting requirements of section 511 of the bill and new section 6038D of the Code requiring disclosure of information with respect to foreign financial assets. It is anticipated that the Secretary will exercise regulatory authority under this provision or new section 6038D to avoid duplicative reporting.

Effective Date

The provision is effective on the date of enactment.

2. Secretary permitted to require financial institutions to file certain returns related to withholding on foreign transfers electronically (sec. 522 of the bill and sec. 6011 of the Code).

Present Law

Withholding responsibility

A withholding agent is any person required to withhold U.S. income tax under sections 1441, 1442, 1443, or 1461. For purposes of these sections, a withholding agent is any person, whether a U.S. or a foreign person, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding.[438] A withholding agent is personally liable for the tax required to be withheld.[439]

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the gain recognized on the deemed sale of the shareholder's interest in the PFIC, or to treat such shareholder's share of the PFIC's post-1986 earnings and profits as an excess distribution, on the last day of its last tax year as a PFIC under section 1297(a) if eligible; or (vi) an election to mark-to-market the PFIC stock that is marketable within the meaning of section 1296(e).

[436] Sec. 1291(e) by reference to sec. 1246(f).

[437] Prop. Treas. Reg. sec. 1.1291-1(i).

[438] Treas. Reg. sec. 1.1441-7(a)(1).

[439] Sec. 1461.

Reporting liability of a withholding agent

Every withholding agent must file an annual return with the IRS on Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," reporting all taxes withheld during the preceding year and remitting any taxes still owing for such preceding year.[440] IRS Form 1042 must be filed on or before March 15 of the year following the year of the payment. The form must be filled even though no tax has been withheld from income paid during the year.[441] A withholding agent must also file an information return, IRS Form 1042-S, which is entitled "Foreign Person's U.S. Source Income Subject to Withholding," on or before March 15 of year the succeeding the year of payment. IRS Form 1042-S requires the withholding agent to provide all items of income specified in section 1441(b) paid during the previous year to foreign persons.[442] IRS Form 1042-S must be filed for each foreign recipient to whom payments were made during the preceding year,[443] even if no tax was required to have been withheld. A copy of IRS Form 1042-S must be sent to the payee.

IRS's authority to require electronic filing

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[444] states that it is a congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

The Secretary has limited authority to issue regulations specifying which returns must be filed electronically. First, such regulations can only apply to persons required to file at least 250 returns during the year.[445] Second, the Secretary is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper (although these returns may be filed electronically by choice). Third, the Secretary, in determining which returns must be filed on magnetic media, must take into account relevant factors, including the ability of a taxpayer to comply with magnetic media filing at reasonable cost.[446] Finally, a failure to comply with the regulations mandating electronic filing cannot in itself support a

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[440] Treas. Reg. sec.1.1461-1(b)(1).

[441] *Ibid.*

[442] Treas. Reg. sec. 1.1461-1(c)(1). IRS Form 1042-S filings provide information important for the Secretary's purposes in properly effecting refund claims and in meeting IRS's obligations under exchange of information agreements with various treaty partners. Also, the IRS has the ability to validate electronically filed Form 1042-S upon such filing, thereby serving to better ensure the reliability of information included in such filings.

[443] *Ibid.* If payments are made to a nominee or representative of a foreign payee, Form 1042-S must also be sent to the beneficial owner of such payments, if known to the withholding agent.

[444] Pub. L. No. 105-206 (1998).

[445] Partnerships with more than 100 partners are required to file electronically. Sec. 6011(e)(2).

[446] Sec. 6011(e).

penalty for failure to file an information return, with certain exceptions for corporations and partnerships.[447]

Accordingly, the Secretary requires corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns to file electronically their Form IRS 1120/1120-S income tax returns and IRS Form 990 information returns for tax years ending on or after December 31, 2006. Private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their IRS Form 990-PF information returns for tax years ending on or after December 31, 2006, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden.

Explanation of Provision

The provision provides an exception to the general annual 250 returns threshold and permits the Secretary to issue regulations to require filing on magnetic media for any return filed by a "financial institution"[448] with respect to any taxes withheld by the "financial institution" for which it is personally liable.[449] Under the provision, the Secretary is authorized to require a financial institution to electronically file returns with respect to any taxes withheld by the financial institution even though such financial institution would be required to file less than 250 returns during the year.

The provision also makes a conforming amendment to section 6724, permitting assertion of a failure to file penalty under section 6721 against a financial institution that fails to comply with the electronic filing requirements.

Effective Date

The provision applies to returns the due date for which (determined without regard to extensions) is after the date of enactment.

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[447] Sec. 6724(c). If a corporation fails to comply with the electronic filing requirements for more than 250 returns that it is required to file, it may be subject to the penalty for failure to file information returns under section 6721. For partnerships, the penalty may only be imposed if the failure extends to more than 100 returns.

[448] See section 1471(d)(5) in section 101 of the bill.

[449] The "financial institution" is personally liable for any tax withheld in accordance with section 1461 and the proposed section 1474(a) under section 101 of the bill.

D. Provisions Related to Foreign Trusts

1. Clarifications with respect to foreign trusts which are treated as having a United States beneficiary (sec. 531 of the bill and sec. 679 of the Code)

Present Law

Under the grantor trust rules, a U.S. person that directly or indirectly transfers property to a foreign trust[450] is generally treated as the owner of the portion of the trust comprising the transferred property for any taxable year in which there is a U.S. beneficiary of any portion of the trust.[451] This treatment generally does not apply to transfers by reason of death, or to transfers of property to the trust in exchange for at least the fair market value of the transferred property.[452] A trust is treated as having a U.S. beneficiary for the taxable year unless (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.[453]

Regulations under section 679 employ a broad approach in determining whether a foreign trust is treated as having a U.S. beneficiary. The determination of whether the trust has a U.S. beneficiary is made for each taxable year of the transferor. The default rule under the statute and regulations is that a trust has a U.S. beneficiary unless during the U.S. transferor's taxable year the trust meets the two requirements as stated above. Income or corpus may be paid or accumulated to or for the benefit of a U.S. person if, directly or indirectly, income may be distributed to or accumulated for the benefit of a U.S. person, or corpus of the trust may be distributed to or held for the future benefit of a U.S. person.[454] The determination is made without regard to whether income or corpus is actually distributed, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event. A person who is not a named beneficiary and is not a member of a class of beneficiaries will not be taken into account if the transferor can show that the person's contingent interest in the trust is so remote as to be negligible.[455] In considering whether a foreign trust has a U.S. beneficiary under the terms of the trust, the trust instrument must be read together with other relevant factors

[450] A trust is a foreign trust if it is not a U.S. person. Sec. 7701(a)(31)(B). A trust is a U.S. person if (1) a U.S. court is able to exercise primary supervision over the administration of the trust, and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. Sec. 7701(a)(30)(E).

[451] Sec. 679(a)(1). This rule does not apply to transfers to trusts established to fund qualified deferred compensation plans or to trusts exempt from tax under section 501(c)(3).

[452] Sec. 679(a)(2).

[453] Sec. 679(c)(1).

[454] Treas. Reg. sec. 1.679-2(a)(2)(i).

[455] Treas. Reg. sec. 1.679-2(a)(2)(ii).

including (1) all written and oral agreements and understandings related to the trust, (2) memoranda or letters of wishes, (3) all records that relate to the actual distribution of income and corpus, and (4) all other documents that relate to the trust, whether or not of any purported legal effect.[456] Other factors taken into account in determining whether a foreign trust is deemed to have a U.S. beneficiary include whether (1) the terms of the trust allow the trust to be amended to benefit a U.S. person, (2) the trust instrument does not allow such an amendment, but the law applicable to the foreign trust may require payments or accumulations of income or corpus to a U.S. person, or (3) the parties to the trust ignore the terms of the trust, or it reasonably expected that they will do so to benefit a U.S. person.[457]

If a foreign trust that was not treated as a grantor trust acquires a U.S. beneficiary and is treated as a grantor trust under section 679 for the taxable year, the transferor is taxable on the trust's undistributed net income[458] computed at the end of the preceding taxable year.[459] Any additional amount included in the transferor's gross income as a result of this provision is subject to the interest charge rules of section 668.[460]

Explanation of Provision

In determining whether, under section 679, a foreign trust has a U.S. beneficiary, the provision clarifies that an amount is treated as accumulated for the benefit of a U.S. person even if the U.S. person's interest in the trust is contingent on a future event. Under the provision, if any person has the discretion (by authority given in the trust agreement, by power of appointment, or otherwise) to make a distribution from the trust to, or for the benefit of, any person, the trust is treated as having a U.S. beneficiary unless (1) the terms of the trust specifically identify the class of persons to whom such distributions may be made, and (2) none of those persons is a U.S. person during the taxable year. The provision is meant to be consistent with existing regulations under section 679.

The provision clarifies that if any U.S. person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding (whether written, oral, or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a U.S. person, such agreement or understanding is treated as a term of the trust. It is assumed for these purposes that a transferor of property to the trust is generally directly or indirectly involved with agreements regarding the accumulation or disposition of the income and corpus of the trust.

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[456] Treas. Reg. sec. 1.679-2(a)(4)(i).

[457] Treas. Reg. sec. 1.679-2(a)(4)(ii).

[458] Undistributed net income is defined in section 665(a).

[459] Sec. 679(b).

[460] Treas. Reg. sec. 1.679-2(c)(1).

Effective Date

The provision is effective on the date of enactment.

2. Presumption that foreign trust has United States beneficiary (sec. 532 of the bill and sec. 679 of the Code)

Present Law

Under the grantor trust rules, a U.S. person that directly or indirectly transfers property to a foreign trust[461] is generally treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust.[462] This treatment generally does not apply to transfers by reason of death, or to transfers of property to the trust in exchange for at least the fair market value of the transferred property.[463] A trust is treated as having a U.S. beneficiary for the taxable year unless (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.[464]

Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. Within 90 days after a U.S. person transfers property to a foreign trust, the transferor must provide written notice of the transfer to the Secretary.[465]

Explanation of Provision

Under the provision, if a U.S. person directly or indirectly transfers property to a foreign trust,[466] the Secretary may treat the trust as having a U.S. beneficiary for purposes of section 679 unless such U.S. person submits information as required by the Secretary and demonstrates to the satisfaction of the Secretary that (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S.

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[461] A trust is a foreign trust if it is not a U.S. person. Sec. 7701(a)(31)(B). A trust is a U.S. person if (1) a U.S. court is able to exercise primary supervision over the administration of the trust and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. Sec. 7701(a)(30)(E).

[462] Sec. 679(a)(1). This rule does not apply to transfers to trusts established to fund qualified deferred compensation plans or to trusts exempt from tax under section 501(c)(3).

[463] Sec. 679(a)(2).

[464] Sec. 679(c)(1).

[465] Sec. 6048(a).

[466] A foreign trust for this purpose does not include deferred compensation and charitable trusts described in section 6048(a)(3)(B)(ii).

person, and (2) if the trust were terminated during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.

Effective Date

The provision applies to transfers of property after the date of enactment.

3. Uncompensated use of trust property (sec. 533 of the bill and secs. 643 and 679 of the Code)

Present Law

Under section 643(i), a loan of cash or marketable securities made by a foreign trust to any U.S. grantor, U.S. beneficiary, or any other U.S. person who is related to a U.S. grantor or U.S. beneficiary is treated as a distribution by the foreign trust to such grantor or beneficiary. This rule applies for purposes of determining if the foreign trust is a simple or complex trust, computing the distribution deduction for the trust, determining the amount of gross income of the beneficiaries, and computing any accumulation distribution. Loans to tax-exempt entities are excluded from this rule.[467] A trust treated under this rule as making a distribution is not treated as a simple trust for the year of the distribution.[468] This rule does not apply for purposes of determining if a trust has a U.S. beneficiary under section 679.

A subsequent repayment, satisfaction, or cancellation of a loan treated as a distribution under section 643(i) is disregarded for tax purposes.[469] This section applies a broad set of related party rules that treat a loan of cash or marketable securities to a spouse, sibling, ancestor, descendant of the grantor or beneficiary, other trusts in which the grantor or beneficiary has an interest, and corporations or partnerships controlled by the beneficiary or grantor or by family members of the beneficiary or grantor, as a distribution to the related grantor or beneficiary.[470]

Explanation of Provision

The provision expands section 643(i) to provide that any use of trust property by the U.S. grantor, U.S. beneficiary or any U.S. person related to a U.S. grantor or U.S. beneficiary is treated as a distribution of the fair market value of the use of the property to the U.S. grantor or U.S. beneficiary. The use of property is not treated as a distribution to the extent that the trust is paid the fair market value for the use of the property within a reasonable period of time. A subsequent return of property treated as a distribution under section 643(i) is disregarded for tax purposes.

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[467] Sec. 643(i)(2)(C).

[468] Sec. 643(i)(2)(D).

[469] Sec. 643(i)(3).

[470] Section 643(i)(2)(B) treats a person as a related person if the relationship between such person would result in a disallowance of losses under sections 267 or 707(b), broadened to include the spouses of members of the family described in such sections.

For purposes of determining whether a foreign trust has a U.S. beneficiary under section 679, a loan of cash or marketable securities or the use of any other trust property by a U.S. person is treated as a payment from the trust to the U.S. person in the amount of the loan or the fair market value of the use of the property. A loan or use of property is not treated as a payment to the extent that the U.S. person repays the loan at a market rate of interest or pays the fair market value for the use of the trust property within a reasonable period of time.

Effective Date

The provision applies to loans made and uses of property after the date of enactment.

4. Reporting requirement of United States owners of foreign trusts (sec. 534 of the bill and sec. 6048 of the Code)

Present Law

Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. If a U.S. person is treated as the owner of any portion of a foreign trust under the rules of subpart E of part I of subchapter J of chapter 1 (grantor trust provisions), the U.S. person is responsible for ensuring that the trust files a tax return for the year and that the trust provides other information as the Secretary may require to each U.S. person who (1) is treated as the owner of any portion of the trust, or (2) receives (directly or indirectly) any distribution from the trust.[471]

Explanation of Provision

The provision requires a U.S. person that is treated as an owner of any portion of a foreign trust under the rules of subpart E of part I of subchapter J of chapter 1 (grantor trust provisions) to provide information as the Secretary may require with respect to the trust, in addition to ensuring that the trust complies with its reporting obligations.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

5. Minimum penalty with respect to failure to report on certain foreign trusts (sec. 535 of the bill and sec. 6677 of the Code)

Present Law

Minimum penalty with respect to failure to report on certain foreign trusts

Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. Generally, a trust is a foreign trust unless a U.S. court is able to exercise primary supervision over the trust's

[471] Sec. 6048(b)(1).

administration and a U.S. trustee has authority to control all substantial decisions of the trust.[472] If a U.S. person creates or transfers property to a foreign trust, the U.S. person generally must report this event and certain other information by the due date for the U.S. person's tax return, including extensions, for the tax year in which the creation of the trust or the transfer occurs.[473] Similar rules apply in the case of the death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or if any portion of a foreign trust was included in the decedent's gross estate. If a U.S. person directly or indirectly receives a distribution from a foreign trust, the U.S. person generally must report the distribution by the due date for the U.S. person's tax return, including extensions, for the tax year during which the distribution is received.[474] If a U.S. person is the owner of any portion of a foreign grantor trust at any time during the year, the person is responsible for causing an information return to be filed for the trust, which must, among other things, give the name of a U.S. agent for the trust.[475]

If a notice or return required under the rules just described is not filed when due or is filed without all required information, the person required to file is generally subject to a penalty based on the "gross reportable amount."[476] The gross reportable amount is (1) the value of the property transferred to the foreign trust if the delinquency is failure to file notice of the creation of or a transfer to a foreign trust; (2) the value (on the last day of the year) of the portion of a grantor trust owned by a U.S. person who fails to cause an annual return to be filed for the trust; and (3) the amount distributed to a distributee who fails to report distributions.[477] The initial penalty is 35 percent of the gross reportable amount in cases (1) and (3) and five percent in case (2).[478] If the return is more than 90 days late, additional penalties are imposed of $10,000 for every 30 days the delinquency continues, except that the aggregate of the penalties may not exceed the gross reportable amount.[479]

<u>Maximum penalty with respect to failure to report on certain foreign trusts</u>

In no event may the penalties imposed with respect to any failure to report under section 6048 exceed the gross reportable amount.[480]

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[472] Sec. 7701(a)(30)(E), (31)(B). In addition, for purposes of section 6048, the IRS can classify a trust as foreign if it "has substantial activities, or holds substantial property, outside the United States." Sec. 6048(d)(2).

[473] Sec. 6048(a).

[474] Sec. 6048(c).

[475] Sec. 6048(b).

[476] Sec. 6677(a).

[477] Sec. 6677(c).

[478] Sec. 6677(b).

[479] Sec. 6677(a).

[480] Ibid.

Explanation of Provision

Increase of the minimum penalty with respect to failure to report on certain foreign trusts

Under the provision, the initial penalty for failing to report under section 6048 is the greater of $10,000 or 35 percent of the gross reportable amount in cases (1) and (3) and the greater of $10,000 or five percent of the gross reportable amount in case (2). Thus, an initial penalty of $10,000 may be imposed even where the Secretary has insufficient information to determine the gross reportable amount. The additional $10,000 penalty for every additional 30 days of delinquency continues to apply.

Amendment to the maximum penalty with respect to failure to report on certain foreign trusts

The provision provides that the penalties with respect to failure to report on certain foreign trusts may exceed the gross reportable amount. However, to the extent that a taxpayer provides sufficient information for the Secretary to determine that the aggregate amount of the penalties exceeds the gross reportable amount, the Secretary is required to refund such excess to the taxpayer.

Effective Date

The provision applies to notices and returns required to be filed after December 31, 2009.

E. Substitute Dividends and Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends (sec. 541 of the bill and sec. 871 of the Code)

Present Law

Payments of U.S.-source "fixed or determinable annual or periodical" income, including interest, dividends, and similar types of investment income, made to foreign persons are generally subject to U.S. tax, collected by withholding, at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[481] Dividends paid by a domestic corporation are generally U.S.-source[482] and therefore potentially subject to withholding tax when paid to foreign persons.

The source of notional principal contract income generally is determined by reference to the residence of the recipient of the income.[483] Consequently, a foreign person's income related to a notional principal contract that references stock of a domestic corporation, including any amount attributable to, or calculated by reference to, dividends paid on the stock, generally is foreign source and is therefore not subject to U.S. withholding tax.

In contrast, a substitute dividend payment made to the transferor of stock in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as actual dividends paid on the transferred stock.[484] Accordingly, because dividends paid with respect to the stock of a U.S. company are generally U.S. source, if a foreign person lends stock of a U.S. company to another person (or sells the stock to the other person and later repurchases the stock in a transaction treated as a loan for U.S. federal income tax purposes) and receives substitute dividend payments from that other person, the substitute dividend payments are U.S. source and are generally subject to U.S. withholding tax.[485] In 1997, the Treasury and IRS issued Notice 97-

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[481] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b). For purposes of the withholding tax rules applicable to payments to nonresident alien individuals and foreign corporations, a withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[482] Sec. 861(a)(2).

[483] Treas. Reg. sec. 1.863-7(b)(1). A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Treas. Reg. sec. 1.446-3(c)(1).

[484] Treas. Reg. sec. 1.861-3(a)(6). This regulation defines a substitute dividend payment as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.

[485] For purposes of the imposition of the 30-percent withholding tax, substitute dividend payments (and substitute interest payments) received by a foreign person under a securities lending or sale-repurchase transaction have the same character as dividend (and interest) income received in respect of the transferred security. Treas. Reg. secs. 1.871-7(b)(2), 1.881-2(b)(2).

66 to address concerns that the sourcing rule just described (and the accompanying character rule) could cause the total U.S. withholding tax imposed in a series of securities lending or sale-repurchase transactions to be excessive.[486] In that Notice, the Treasury and IRS also stated that they intended to propose new regulations to provide detailed guidance on how substitute dividend payments made by one foreign person to another foreign person were to be treated. To date, no regulations have been proposed.[487]

Explanation of Provision

The provision treats a dividend equivalent as a dividend from U.S. sources for certain purposes, including the U.S. withholding tax rules applicable to foreign persons.

A dividend equivalent is any substitute dividend (as defined in Treas. Reg. section 1.861-3(a)(6)) or any payment made under a specified notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. A dividend equivalent also includes any other payment that the Secretary determines is substantially similar to a payment described in the immediately preceding sentence. Under this rule, for example, the Secretary may conclude that payments under certain forward contracts or other financial contracts that reference stock of U.S. corporations are dividend equivalents.

A specified notional principal contract is any notional principal contract that has any one of the following five characteristics: (1) In connection with entering into the contract, any long party transfers the underlying security;[488] (2) in connection with the termination of the contract, any short party transfers the underlying security to any long party; (3) the underlying security is not readily tradable on an established securities market; (4) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral; or (5) the Secretary identifies the contract as a specified notional principal contract.[489] For purposes of these characteristics, for any underlying security of any notional principal contract (1) a long party is any party to the contract that is entitled to receive any payment under the contract that is contingent upon or determined by reference to the payment of a U.S.-source dividend on the

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[486] Notice 97-66, 1997-2 C.B. 328 (December 1, 1997).

[487] There is evidence that some taxpayers have taken the position that Notice 97-66 sanctions the elimination of withholding tax in certain situations. See United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, Staff Report, September 11, 2008, pp. 18-20, 22-23, 40, 47, 52. In the Obama administration's fiscal year 2010 budget, the Treasury Department has announced that, to address the avoidance of U.S. withholding tax through the use of securities lending transactions, it plans to revoke Notice 97-66 and issue guidance that eliminates the benefits of those transactions but minimizes over-withholding. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, May 2009, p. 37.

[488] The Secretary may issue guidance addressing the application of this rule in circumstances in which the long party transfers the underlying security to an unrelated third party.

[489] Any notional principal contract identified by the Secretary as a specified notional principal contract will be subject to the provision's general effective date described below.

underlying security, and (2) a short party is any party to the contract that is not a long party in respect of the underlying security. An underlying security in a notional principal contract is the security with respect to which the dividend equivalent is paid. For these purposes, any index or fixed basket of securities is treated as a single security.

For payments made more than two years after the provision's date of enactment, a specified notional principal contract also includes any notional principal contract unless the Secretary determines that the contract is of a type that does not have the potential for tax avoidance.

No inference is intended as to whether the definition of specified notional principal contract, or any determination under this provision that a transaction does not have the potential for the avoidance of taxes on U.S.-source dividends, is relevant in determining whether an agency relationship exists under general tax principles or whether a foreign party to a contract should be treated as having beneficial tax ownership of the stock giving rise to U.S.-source dividends.

The payments that are treated as U.S.-source dividends under the provision are the gross amounts that are used in computing any net amounts transferred to or from the taxpayer. The example of a "total return swap" referencing stock of a domestic corporation (an example of a notional principal contract to which the provision generally applies), illustrates the consequences of this rule. Under a typical total return swap, a foreign investor enters into an agreement with a counterparty under which amounts due to each party are based on the returns generated by a notional investment in a specified dollar amount of the stock underlying the swap. The investor agrees for a specified period to pay to the counterparty (1) an amount calculated by reference to a market interest rate (such as the London Interbank Offered Rate ("LIBOR")) on the notional amount of the underlying stock and (2) any depreciation in the value of the stock. In return, the counterparty agrees for the specified period to pay the investor (1) any dividends paid on the stock and (2) any appreciation in the value of the stock. Amounts owed by each party under this swap typically are netted so that only one party makes an actual payment. The provision treats any dividend-based amount under the swap as a payment even though any actual payment under the swap is a net amount determined in part by other amounts (for example, the interest amount and the amount of any appreciation or depreciation in value of the referenced stock). Accordingly, a counterparty to a total return swap may be obligated to withhold and remit tax on the gross amount of a dividend equivalent even though, as a result of a netting of payments due under the swap, the counterparty is not required to make an actual payment to the foreign investor.

If there is a chain of dividend equivalents (under, for example, transactions similar to those described in Notice 97-66), and one or more of the dividend equivalents is subject to tax under the provision or under section 881, the Secretary may reduce that tax, but only to the extent that the taxpayer establishes that the tax has been paid on another dividend equivalent in the chain. An actual dividend is treated as a dividend equivalent for purposes of this rule.

For purposes of chapter 3 (withholding of tax on nonresident aliens and foreign corporations) and chapter 4 (taxes to enforce reporting on certain foreign accounts), each person that is a party to a contract or other arrangement that provides for the payment of a dividend equivalent is treated as having control of the payment. Accordingly, Treasury may provide guidance requiring either party to withhold tax on dividend equivalents.

The rule treating dividend equivalents as U.S.-source dividends is not intended to limit the authority of the Secretary (1) to determine the appropriate source of income from financial arrangements (including notional principal contracts) under present law section 863 or 865 or (2) to provide additional guidance addressing the source and characterization of substitute payments made in securities lending and similar transactions.

Effective Date

The provision applies to payments made on or after the date that is 90 days after the date of enactment.

TITLE VI − OTHER REVENUE PROVISIONS

A. Income of Partners for Performing Investment Management Services Treated as Ordinary Income Received for Performance of Services (secs. 601 and 602 of the bill and secs. 83, 710, 856, 1402, 6662, 6662A, 6664, and 7704 of the Code)

Present Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxable upon the receipt of the partnership interest.[490]

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.[491] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[492] 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.[493]

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

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[490] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T. C. 530 (1971), *aff'd* 492 F.2d 286 (7th Cir. 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner*, 943 F. 2d 815 (8th Cir. 1991)).

[491] Rev. Proc. 93-27 (1993-2 C.B. 343) citing the *Diamond* and *Campbell* cases, *supra*.

[492] Rev. Proc. 2001-43 (2001-2 C.B. 191).

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

performance of services.[494] 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.[495]

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[496] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

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[494] 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).

[495] Rev. Proc. 93-27, 1993-2 C.B. 343.

[496] Sec. 83(h).

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[497] The proposed regulations provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also permit a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant) in a partnership, under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[498] 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 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

[497] 70 Fed. Reg. 29675 (May 24, 2005).

[498] Sec. 702.

Insurance Contributions Act ("FICA").[499] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA") .[500]

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[501] The amount of wages subject to this component is capped at $106,800 for 2009. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[502]

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $106,800 for 2009. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.[503] 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

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[499] *See* Chapter 21 of the Code.

[500] Sec. 1401.

[501] Secs. 3101 and 3111.

[502] 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.

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

types of income, such as capital gains and dividends, as described above). This rule applies to individuals who are general partners.

A special rule applies for limited partners of a partnership.[504] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

Income tax treatment of publicly traded partnerships

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

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 a 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

[504] Sec. 1402(a)(13).

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.)

The 1987 legislation provided a transition rule grandfathering existing partnerships for 10 years. Under the transition rule, in the case of partnerships existing on December 31, 1987, the general rule treating publicly traded partnerships as corporations applied for taxable years beginning after December 31, 1997.[505] A partnership was not treated as an existing partnership for this purpose if a substantial new line of business was added.

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.[506] 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").

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[505] The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added section 7704(g), permitting electing 1987 partnerships not to be subject to the general rule treating publicly traded partnerships as corporations and to be subject to an additional tax.

[506] 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.

Accuracy-related penalties

An accuracy-related penalty of 20 percent is imposed under section 6662 on the portion of any underpayment of tax attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.[507] An understatement of income tax is the excess of the amount of tax properly required to be shown on a return over the amount actually shown on the return, subject to certain reductions.[508] An understatement is substantial for a noncorporate taxpayer if the amount of the understatement exceeds the greater of (1) 10 percent of the correct tax liability or (2) $5,000.[509] For corporate taxpayers an understatement is substantial if it exceeds the lesser of (1) 10 percent of the correct tax liability (or $10,000 if greater) or (2) $10,000,000.[510]

Similarly, section 6662A imposes a 20-percent penalty on reportable transaction understatements, that is, understatements involving listed transactions or any reportable transaction (other than a listed transaction) if a significant purpose of the transaction is the avoidance or evasion of Federal income tax.[511] The penalty rate is increased to 30 percent for transactions subject to 6662A which are not adequately disclosed in accordance with section 6011 and the regulations promulgated thereunder.[512]

The section 6662 accuracy-related penalty is not imposed on an underpayment (or portion thereof) if the taxpayer demonstrates a reasonable cause for the underpayment and the taxpayer acted in good faith.[513] The section 6662A reportable transaction understatement penalty is subject to a more stringent reasonable cause exception (commonly referred to as the "strengthened reasonable cause exception"). In addition to demonstrating reasonable cause and good faith, to avoid application of the section 6662A penalty a taxpayer must demonstrate (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011, (2) that there is or was substantial authority for such treatment, and (3) reasonable belief that such treatment was more likely than not the proper treatment. A reasonable belief must be based on the facts and law as they exist at the time that the return in question is filed and must relate solely to the taxpayer's chances of success on the merits of the treatment.[514]

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[507] Sec. 6662. The penalty rate is increase to 40 percent for gross valuation misstatements. Sec. 6662(h).

[508] Sec. 6662(d)(2). An understatement is generally reduced by amounts attributable to (1) positions for which the taxpayer has substantial authority, or (2) items adequately disclosed and for which the taxpayer has a reasonable basis. The reduction does not apply to tax shelter items.

[509] Sec. 6662(d)(1)(A).

[510] Sec. 6662(d)(1)(B).

[511] Sec. 6662A(b)(2).

[512] Sec. 6662A(c).

[513] Sec. 6664(c).

[514] Sec. 6664(d)(3).

Moreover, reliance on professional advice may support a taxpayer's reasonable belief only in certain circumstances.[515]

Explanation of Provision

Partnership interests transferred in connection with the performance of services under section 83

In the case of a transfer after the date of enactment of any interest in a partnership in connection with the provision of services to or for the benefit of the partnership, the bill provides for a determination of the fair market value of the partnership interest, and provides that the recipient of the partnership interest is deemed to have made the section 83(b) election unless the person affirmatively elects otherwise. Thus, absent such an election, a transferee of a partnership interest for services must include in income for the taxable year of the transfer the fair market value (if any) of the partnership interest.

For purposes of section 83, the fair market value of the partnership interest is generally its liquidation value; that is, specifically, the fair market value is deemed to be the amount the partner would receive if, at the time of transfer of the partnership interest, the partnership had sold all its assets at fair market value and distributed the proceeds (reduced by partnership liabilities) to the partners in liquidation of the partnership.

Recharacterization as ordinary income

The provision generally treats net income from an investment services partnership interest as ordinary income except to the extent it is attributable to the partner's qualified capital interest. Thus, the provision 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). Any amount treated as ordinary income or ordinary loss from an investment services partnership interest is included in determining net earnings from self-employment.

The provision provides that an investment services partnership interest is a partnership interest held (directly or indirectly) by any person if it was reasonably expected (at the time the person acquired the partnership interest) that the person (or any related person) would provide, or

[515] Section 6664(d)(3)(B) does not allow a reasonable belief to be based on a "disqualified opinion" or on an opinion from a "disqualified tax advisor."

already has provided, (directly or indirectly) a substantial quantity of certain services with respect to assets held (directly or indirectly) by the partnership. The services are: (1) advising as to the advisability of investing in, purchasing, or selling any specified asset; (2) managing, acquiring, or disposing of any specified asset; (3) arranging financing with respect to acquiring specified assets; (4) any activity in support of any of the foregoing services. Activities in support of these services are intended to include supervising others who perform the services as well as assisting others who perform the services.

For this purpose, specified assets means securities (as defined in section 475(c)(2) without regard to the last sentence), real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), or options or derivative contracts with respect to such securities, real estate, partnership interests, 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 partnership interest includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a private equity fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.[516] For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm. 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.

For purposes of this rule, assets held (directly or indirectly) by the partnership are considered to include assets held through any other entity, including a corporation. It is intended that the general rule not be avoided by means of arrangements though which a partner has the right to income or gains based on the performance of assets while taking the position that the partnership does not directly or indirectly hold the assets. Similarly, it is intended that the general rule not be avoided by disposing at capital gains rates (or on a tax-favored basis) of rights to receive income or gains based on the performance of assets. Treasury regulatory authority is provided to implement this intent. For example, such a disposition may be treated as giving rise to ordinary income under Treasury guidance under the provision (described below) relating to a disqualified interest in the form of a derivative instrument with respect to an entity.

[516] It is intended that income from providing the services described above with respect to the business or assets of the partnership in which the partner (directly or indirectly) holds a partnership interest is subject to the recharacterization rule of the provision.

The provision does not apply to services other than those giving rise to an investment services partnership interest. For example, assume that three individuals form a partnership to operate a biotechnology business; two each contribute $1 million in cash, and the third contributes his personal services as a research scientist. In the following year, the business profits of the partnership are $300,000, and the partnership agreement provides that each of the three partners' distributive share is $100,000. The profits are ordinary income to the partners under present law, so the provision does not affect the income tax rate applicable to the partners.[517] In the following year, the third partner sells his partnership interest. Because the third partner's services do not consist of the services described above, the gain on sale of the partnership interest is not subject to recharacterization under the provision. As another example, assume instead that a partnership of three individuals is formed to manage investments in specified assets. The first two individuals contribute $1 million each and the third contributes his personal services advising the partnership as to the advisability of investing in particular specified assets, and managing, acquiring, arranging financing for, and disposing of such assets. In the following year, the profits of the partnership are $300,000, and the partnership agreement provides that each of the three partners' distributive share is $100,000. Because the third partner's services consist of the services described above with respect to specified assets, the third partner's share of profits is subject to recharacterization under the provision. When the third partner sells his partnership interest in the following year, the gain is recharacterized as ordinary income under the provision.[518]

Exception for qualified capital interest

In general

The provision provides an exception to recharacterization as ordinary in the case of items of income, gain, loss, and deduction that are allocated to the portion of an investment services partnership interest that is a qualified capital interest, provided other requirements are met.

Allocations to qualified capital interests

These requirements are met if (1) items are allocated to the service providing partner's qualified capital interest in the same manner as the items are allocated to other qualified capital interests of partners that do not provide any of the described services and that are not related to the service-providing partner, and (2) the allocations made to the qualified capital interests of unrelated non-service providing partners are significant compared to the allocations made to the service providing partner's qualified capital interest.

Items allocated among the partners in proportion to each partner's qualified capital may be considered as allocated in the same manner, under this rule, if the qualified capital interests to

[517] The income generally is subject to self-employment tax under present law in the hands of a general partner, or a limited partner receiving guaranteed payments as remuneration for services, without regard to the provision.

[518] The rule providing that gain is treated as ordinary income on the disposition of an investment services partnership interest is described below.

which the allocations are made are substantially identical as to the degree of risk and with respect to all other economically significant aspects, benefits and burdens. For example, items are not allocated in the same manner under this rule if they are allocated in the same proportion to riskier interests and to safer interests. Similarly, items are not considered as allocated in the same manner under this rule if allocations to qualified capital interests of nonservice providing partners are artificially high while returns that are below market, or artificially low, are made to other types of interests (for example, debt) held by the nonservice providing partners.

A special rule applies in the case of no or insignificant partnership allocations to unrelated nonservice providers. The special rule applies, to the extent provided in Treasury guidance, in any case in which allocations to unrelated nonservice providers' qualified capital interests are not significant compared to allocations made to the service provider's qualified capital interest. Under the special rule, partnership items of income, gain, loss, and deduction are not recharacterized as ordinary under the general rule of the provision, to the extent the items are properly allocable to the qualified capital interests as provided in the Treasury guidance.

For example, it would be appropriate for Treasury guidance to implement the special rule in the case in which all of the partners of the partnership are service providers, so there are no unrelated nonservice providers. It is anticipated that Treasury guidance may provide that pro rata allocation of partnership items to qualified capital interests generally satisfies the special rule in this situation. It is anticipated that the Treasury guidance will take into account whether the partnership agreement provides for proper allocation of the items among the partners and, with respect to a service provider, as between the partner's qualified capital interest and the remainder of the partner's interest in the partnership.

Definition of qualified capital interest

A qualified capital interest means the amount of a partner's interest in partnership capital attributable to (1) the fair market value of money or other property contributed by the partner to the partnership in exchange for the partnership interest (determined without regard to the deemed contribution rules of section 752(a), and without regard to any other deemed contribution), (2) the amount included in the partner's gross income under section 83 with respect to the transfer of the partnership interest by the partnership for services, and (3) the partner's distributive share of cumulative net income and gain of the partnership included in the partner's income, if any, that has not been distributed by the partnership in taxable years to which the provision applies. The qualified capital interest is reduced by partnership distributions to the partner in taxable years to which the provision applies, and by the partner's share of partnership losses, if any.

In the case of the transfer of an investment services partnership interest in a fully taxable transaction, the transferee partner accedes to the amount of the qualified capital account of the transferor partner. Unlike the basis rules of section 743 in the case of a transfer of a partnership interest, only the amount of the transferor's qualified capital interest is treated as the transferee's qualified capital interest. A qualified capital interest does not include any amount paid to a person other than the partnership; for example, such an interest does not include the price of a partnership interest acquired by purchase from another partner. It is intended that rules similar to the rules of section 197(f)(9) apply.

Loans, advances, guarantees

For purposes of the exception for qualified capital interests, an investment services partnership interest is not treated as acquired by contribution of capital by a service providing partner to the extent of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or by a person related to that other 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 a qualified capital interest 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 the capital interest of that partner, for purposes of determining the amount of the service-providing partner's qualified capital interest (but not, however, for purposes of comparing allocations to the service provider's qualified capital interest to qualified capital interests of non-service-providing unrelated partners). Income and loss treated as allocable to capital interests of partners are adjusted accordingly.

For example, if investors in a private equity fund that is a partnership contribute capital primarily as debt rather than as equity, while the manager of the fund contributes only equity so that his capital interest appears to be a large percentage of the total equity contributed, the provision treats the partnership debt to the investors as the investors' capital interests for this purpose. The percentage of total capital interests 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 capital interest is a smaller percentage of total capital interests than if only equity contributions were taken into account.

Losses, dispositions, and partnership distributions

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

Losses

Consistent with the general rule providing that net income with respect to such a partnership interest is ordinary income, the provision provides that net loss with respect to such a partnership interest (to the extent not disallowed) generally is treated as ordinary loss. For this purpose, net loss means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of income and gain taken into account by the partner with respect to the partnership interest for the partnership taxable year. The net loss is allowed for a partnership taxable year, however, only to the extent that the loss does not exceed the excess (if any) of (1) aggregate net income with respect to the partnership interest for prior partnership taxable years, over (2) the aggregate net loss with respect to the partnership interest not disallowed for prior partnership years. Any net loss that is not allowed for the partnership taxable year is carried forward to the next partnership taxable year.

Notwithstanding the present-law rule that the basis of a partnership interest generally is reduced by the partner's distributive share of partnership losses and deductions (sec. 705(a)(2)), the provision provides that no adjustment is made to the basis of a partnership interest on account of a net loss that is not allowed for the partnership taxable year. When any such net loss that is carried forward is allowed in a subsequent year, the adjustment is made to the basis of the partnership interest.

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 income 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)).

Dispositions

On the disposition of an investment services partnership interest, gain is treated as ordinary income, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest generally is considered as capital gain or loss.[519] Gain on the disposition of an investment services partnership interest is recognized notwithstanding any other income tax provision, such as nonrecognition or deferral rules. Loss on the disposition of an investment services partnership interest is treated as ordinary loss, but only to the extent of the amount by which aggregate net income previously treated as ordinary exceeds aggregate net loss previously allowed as ordinary under the provision.

The amount of net loss that otherwise (but for the rule providing for no basis reduction described above) would have reduced the basis of the investment services partnership interest is disregarded for purposes of the provision, in the event of any disposition of the interest.

On the disposition of an investment services partnership interest, any portion of which is a qualified capital interest, a special rule provides that a proportionate amount of the gain or loss on disposition is not subject to recharacterization as ordinary. Under this special rule, the

[519] Sec. 741; except ordinary treatment applies to the extent gain is attributable to inventory and unrealized receivables under section 751(a). The bill adds investment services partnership interests to this category under section 751(a).

proportionate amount of the gain or loss is determined generally by the ratio of the gain or loss on liquidation of the partner's qualified capital interest to the gain or loss on liquidation of the partner's entire investment services partnership interest (as if the liquidation occurred immediately before the disposition).

Partnership distributions

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 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 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 income (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 ordinary income. 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 ordinary 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 provision also recharacterizes as ordinary income the income or gain with respect to certain other interests, including interests in entities, 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. Rules similar to the exception for a partner's qualified capital interest 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. However, an option to acquire a partnership interest may be a disqualified interest. A disqualified interest also does not include, except as provided otherwise in Treasury regulations or guidance, stock in an S corporation, or except as provided otherwise in Treasury regulations or guidance, stock in a taxable corporation, which for this purpose means either a domestic C corporation or a foreign corporation, substantially all of the income of which is effective connected with the conduct of a trade or business in the United States, or that is subject to a comprehensive foreign income tax. It is not intended that the exception for stock in an S corporation or domestic C corporation permit avoidance of the general rule relating to partnership interests through establishment of economically similar arrangements. 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 United States, or if the corporation demonstrates to the satisfaction of the Treasury Secretary that the foreign country has a comprehensive income tax.

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

Underpayment penalty

The provision provides that the accuracy-related penalty under section 6662 on underpayments applies to underpayments attributable to the failure to comply with section 710(d) (relating to the treatment of income in connection with investment management services involving disqualified interests) or the regulations under section 710(e) to prevent the avoidance of the purposes of section 710. The penalty rate is 40 percent. A strengthened reasonable cause exception similar to that applicable to reportable transaction understatements may apply with respect to the section 710(d) or (e) underpayments if the requirements for it are met. The strengthened reasonable cause exception does not apply unless (1) the relevant facts affecting the tax treatment of the item are adequately disclosed, (2) there is or was substantial authority for the tax treatment, and (3) the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment. Rules similar to the rules of section 6664(d)(3) apply for purposes of determining reasonable belief.

Self-employment tax treatment

Under the provision, in the case of any individual who is engaged in the trade or business of performing the services described in new section 710(c)(1) with respect to any entity, any amount treated as ordinary income or loss from an investment services partnership interest is taken into account in determining self-employment tax. It is intended that an entity include a partnership as well as an entity described in new section 710(d) or guidance thereunder. Because net income or gain from disposition of an investment services partnership is treated as ordinary income, the present-law exception under the self-employment tax rules for gain or loss from the sale or exchange of a capital asset does not apply, even though the net income from the investment service partnership interest might otherwise be characterized as capital gain. The provision applies notwithstanding the present-law special rule for limited partners under the self-employment tax, so the present-law exclusion for limited partners does not apply to any amount treated as ordinary income or loss from an investment services partnership interest under new section 710. Amounts that are not treated as ordinary income under the recharacterization rule of new section 710 because they are allocated to a qualified capital interest and meet applicable requirements under that exception are not taken into account in determining net earnings from self-employment (unless another provision of law requires them to be so taken into account).[520]

Rules relating to publicly traded partnerships

The provision provides that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income of a publicly traded partnership. Thus, for example, if a publicly traded partnership holds a partnership interest that is an investment services partnership interest by reason of the performance of investment management services with respect to specified assets, the publicly traded partnership's income from that partnership interest is not qualifying income for purposes of section 7704. A publicly traded partnership,

[520] Further described above is the rule providing that 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.

more than 10 percent of whose gross income consists of income from an investment services partnership interest, 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 bill provides a transition rule, under which the rule treating income and gain that are ordinary under new section 710 as nonqualifying does not apply to a partnership that is publicly traded on the date of enactment for any taxable year of the partnership that begins before the date 10 years after the date of enactment.

The provision provides a special rule for certain partnerships that are owned by publicly traded REITs and that meet specific requirements. Under the special rule, the general rule that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income of a publicly traded partnership 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). 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.

The provision provides a special rule for certain publicly traded partnerships that own interests in exchange-traded partnerships whose income is ordinary. The general rule that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income of a publicly traded partnership does not apply in the case of a partnership that meets two requirements: (1) substantially all of the partnership's assets are interests in other partnerships that are traded on an established securities market; and (2) substantially all of the partnership' income is ordinary income or section 1231 gain. For this purpose, partnership interests that are readily tradable on a secondary market (or the substantial equivalent thereof) do not qualify; only those that are traded on an established securities market (for example, the New York Stock Exchange) meet the requirement of the special rule. It is intended that a substantial portion of the equity of the partnership be so traded; for example, if less than a substantial portion of the interests of the partnership are traded on an established securities market, the requirement is not satisfied.

Regulatory authority

The Treasury Department shall prescribe such regulations as are necessary or appropriate to carry out the purpose of new section 710, including regulations to provide modifications to the application of this section (including treating related persons as not related to one another) to the extent such modification is consistent with the purposes of this section, to prevent the avoidance of the purposes of the provision, and to coordinate the provision with other provisions of Federal tax law.

It is expected that these regulations will, among other things, address the effects, if any, of the provision on whether income is U.S. or foreign source (or is sourced within a U.S. possession); how income is characterized for purposes of the foreign tax credit limitation rules; whether income is subject to tax by the United States by reason of sections 897 and 1445 (sale of U.S. real property) or is exempt from U.S. tax under section 892 (income of foreign governments); whether income is effectively connected with the conduct of a trade or business within the United States; and whether income is subject to current U.S. tax under the passive foreign investment company or subpart F rules. The intent of the provision is generally not to change the result under these rules, to the extent that is consistent with not providing an opportunity to avoid the recharacterization of income as ordinary under the provision and not creating an opportunity for exclusion or deferral of otherwise includable amounts. For example, it is not intended that the provision be utilized to effect a recharacterization as untaxed foreign-source ordinary income from personal services the amount of any otherwise taxable (or witholdable) 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.

It is not intended that solely the recharacterization of income as ordinary under the provision cause income of a REIT that otherwise meets the requirements of section 856(c)(2), (3), or (4) to fail to meet the requirements of those paragraphs. Similarly, it is not intended that solely the recharacterization of income as ordinary under the provision cause income not otherwise treated as unrelated business income of an exempt organization to fail to meet provisions of section 512(b) that are otherwise satisfied.

It is not intended that income or loss characterized as ordinary under the provision be taken into account in determining net investment income for purposes of the investment interest limitation of section 163(d).

It is not intended that opportunities to avoid or defer income inclusion be created by the recharacterization of income or loss as ordinary under the provision.

Effective Date

The provision relating to transfers of partnership interests under section 83 is effective for partnership interests transferred after the date of enactment.

The provision treating net income from an investment services partnership interest as ordinary is effective generally for taxable years ending after December 31, 2009.

In the case of a partnership taxable year that includes December 31, 2009, the amount of net income of a partner that is recharacterized as ordinary income for the performance of services under the provision is limited to the lesser of (1) net income for the entire partnership taxable year, or (2) net income determined by taking into account only items attributable to the part of the taxable year after December 31, 2009.

The provision is effective for dispositions of partnership interests, and partnership distributions, after December 31, 2009.

The provision relating to income or gain with respect to interests in certain entities other than partnerships that are held by a person who performs, directly or indirectly, investment management services for the entity takes effect on January 1, 2010.

For purposes of applying the rules relating to publicly traded partnerships (section 7704), the provision applies to taxable years beginning after December 31, 2009.

B. Time for Payment of Corporate Estimated Taxes (sec. 611 of the bill and sec. 6655 of the Code)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.[521] 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. In the case of a corporation with assets of at least $1 billion (determined as of the end of the preceding tax year), payments due in July, August, or September, 2014, are increased to 133.25 percent of the payment otherwise due and the next required payment is reduced accordingly.[522]

Explanation of Provision

The provision increases the required payment of estimated tax otherwise due in July, August, or September, 2014, by 26.5 percentage points.

Effective Date

The provision is effective on the date of the enactment of this Act.

[521] Sec. 6655.

[522] Pub. L. No. 111-92, Sec. 18; Pub. L. No. 111-42, sec. 202(b)(1).

C. Study of Extended Tax Expenditures (sec. 621 and 622 of the bill)

Present Law

The Congressional Budget and Impoundment Control Act of 1974[523] ("the Budget Act") created the House and Senate Budget Committees and charged them with the duty "to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies" to the respective chamber of Congress on a recurring basis. It defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[524]

The Budget Act also created the Congressional Budget Office ("CBO"), and requires it to provide an annual report to Congress on "the levels of tax expenditures under existing law, taking into account projected economic factors and any changes in such levels based on provisions in the budget submitted by the President for such fiscal year."[525] In light of the traditional expertise of the staff of the Joint Committee on Taxation ("JCT staff") with respect to revenue matters, and a separate statutory requirement that Congress rely on JCT staff estimates when considering the revenue effects of proposed legislation,[526] the CBO has always relied on the JCT staff for the production of its annual tax expenditure publication.[527]

The Congressional Research Service ("CRS") prepares a biennial publication[528] for the use of the Committee on the Budget of the United States Senate in support of the Budget Act mandate for the Budget Committees to examine tax expenditures as they develop the Congressional Budget Resolution. The publication includes for each provision its legal authorization, a description of the tax provision and its impact, the rationale at the time of adoption, an assessment, and bibliographic citations.

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[523] Pub. L. No. 93-344.

[524] Pub. L. No. 93-344, sec. 3(3), codified at 2 USC 622(3).

[525] Pub. L. No. 93-344, sec. 202(f)(1)(B).

[526] Pub. L. No. 93-344, sec. 201(g), codified at 2 USC 601(f).

[527] See e.g., Joint Committee on Taxation, *Estimates of Federal Tax Expenditures* (JCS-2-08), October 31, 2008.

[528] See e.g., Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 110-667, December 2008.

The U.S. Government Accountability Office ("GAO") issues reports on tax expenditures from time to time in its role of supporting Congressional oversight of how taxpayer dollars are spent.[529]

Explanation of Provision

The provision requires the Chief of Staff of the Joint Committee on Taxation, in consultation with the Comptroller General of the Government Accountability Office, to submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on each tax expenditure extended by this Act. Reports for each tax expenditure enacted in subtitle B of title I (relating to business tax relief) and title IV (relating to energy provisions) are to be submitted first, in order from those with the least aggregate cost for the fiscal year in which this Act is enacted, and the following nine fiscal years, to the greatest aggregate cost for such fiscal years. These cost estimates are determined by the Chief of Staff. Thereafter, reports may be submitted in such order as the Chief of Staff determines appropriate. Reports are due not later than November 30, 2010.

Such reports shall contain the following: (1) an explanation of the tax expenditure and any relevant economic, social, or other context under which it was first enacted; (2) a description of the intended purpose of the tax expenditure; (3) an analysis of the overall success of the tax expenditure in achieving such purpose, and evidence supporting such analysis; (4) an analysis of the extent to which further extending the tax expenditure, or making it permanent, would contribute to achieving such purpose; (5) a description of the direct and indirect beneficiaries of the tax expenditure, including identifying any unintended beneficiaries; (6) an analysis of whether the tax expenditure is the most cost-effective method for achieving the purpose for which it was intended, and a description of any more cost-effective methods through which such purpose could be accomplished; (7) a description of any unintended effects of the tax expenditure that are useful in understanding the tax expenditure's overall value; (8) an analysis of how the tax expenditure could be modified to better achieve its original purpose; (9) a brief description of any interactions (actual or potential) with other tax expenditures or direct spending programs in the same or related budget function worthy of further study; and (10) a description of any unavailable information the staff of the Joint Committee on Taxation may need to complete a more thorough examination and analysis of the tax expenditure, and what must be done to make such information available.

In the event the Chief of Staff concludes it will not be feasible to complete all reports by November 30, 2010, at a minimum, the reports for each tax expenditure enacted in subtitle B of title I (relating to business tax relief) and title IV (relating to energy provisions) shall be completed by such date.

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[529] See e.g., Government Accountability Office, *Home Mortgage Interest Deduction* (GAO-09-769), July 29, 2009, and Government Accountability Office, *Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined* (GAO-05-690), September 23, 2005.

Effective Date

The provision is effective on the date of enactment of this Act.