TAX LEGISLATIVE UPDATE
OR:
OBAMA ADMINISTRATION TAX LAWS

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PART I:
THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009
(Pub. L. 111-5)

I. INTRODUCTION

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 ("ARRA") into law. ARRA contained $787 billion of tax incentives and spending provisions intended to revitalize the economy. The provisions ranged from significant relief for businesses that restructure their debt to those that encourage individuals to make investments in houses and cars. Of note are a number of incentives for investments in energy alternatives to gas and oil.

II. INDIVIDUAL INCOME AND DEDUCTIONS

A. Section 85(c),[1] Unemployment compensation. New subsection (c) to Section 85 excludes from gross income the first $2,400 of unemployment compensation received by an individual for 2009. The exclusion is not phased out at higher income brackets which has led to some negative commentary that the exclusion is not effective since those with lower incomes are in lower tax brackets and thus benefit less from the exclusion.

B. Section 1202(a)(1), Excludable gain on small business stock. Section 1202 generally provided that a noncorporate taxpayer that sells qualified small business stock ("QSBS") which was held for at least 5 years may exclude 50% of the gain from the sale or exchange of such stock. ARRA increased the gain that may be excluded to 75% for stock acquired after February 17, 2009 and before January 1, 2011. The remainder of the gain from the sale of QSBS is taxed at a 28% rate, such that the effective rate of tax on the gain on the sale of QSBS acquired after February 17, 2009, and before January 1, 2011 (and otherwise satisfying the requirements of Section 1202) is 7%.

1. QSBS. Among other requirements, QSBS is stock of a corporation which (1) has had assets not in excess of $50 million since August 9, 1993, and (2) will not have assets in excess of $50 million immediately after issuance of the stock.

C. Section 132(f)(2), Public transportation fringe benefits. Through 2010, the limit on excludable benefits for vanpools and transit passes is increased to match the limit for applicable parking benefits.

D. Section 529(e)(3)(A), Qualified tuition programs. ARRA amends Section 529 to provide that "qualified educational expenses" from a 529 Plan include purchases of computer technology or equipment and internet access in the calendar years 2009 and 2010 so long as the beneficiary of the 529 Plan or his or her family uses the technology, equipment or services while the beneficiary is enrolled at a qualified educational institution. Computer software for games, sports, or hobbies will not qualify.

E. ARRA Section 2201, Economic recovery payments. The Treasury Department will make one-time payments of $250 to adults who are eligible for benefits under certain Social Security, Railroad Retirement, Veterans and Supplemental Security Income (SSI) programs.

F. Section 164(a)(6), New car purchases. Most individuals who purchase qualified motor vehicles before 2010 can deduct some state and local sales and excise taxes, regardless of whether they itemize deductions. The deduction is based upon the purchase price up to the first $49,500, and starts phasing out for individuals with modified adjusted gross income ("MAGI") of $125,000 ($250,000 for joint filers). The deduction will be reduced to zero when the taxpayer's MAGI reaches $135,000 ($260,000 for joint filers).

G. Sections 26 and 55(d)(1)(A), (B), AMT. The increased alternative minimum tax (AMT) exemption amounts and the use of nonrefundable personal tax credits against regular tax and AMT liability are both extended to tax years beginning in 2009. The exemptions will be $70,950 for married individuals filing a joint return and surviving spouses; $46,700 for unmarried individuals; and $35,475 for married individuals filing separate returns.

III. INDIVIDUAL-RELATED TAX CREDITS

A. Section 36A, Making Work Pay Credit. ARRA adds new Section 36A, providing an income tax credit to individuals, who are not: (1) claimed as a dependent by another, (2) an estate or trust, or (3) a nonresident alien. The credit is equal to 6.2% of earned income, but not in an amount that exceeds $400 ($800 for joint filers). The credit is available for both the calendar year 2009 and 2010, but not thereafter. The credit is phased out by 2% of the amount that exceeds $75,000 for an individual and $150,000 for a married couple filing jointly. The credit can be claimed on a timely filed tax return or by a reduction in the income tax withheld. The reduction in income tax withholding for 2009 is about $13 a week and will be about $9 a week in 2010.

B. Section 36, First-time homebuyer credit. The limit on the First-Time Homebuyer's Credit, which is equal to 10% of the purchase price of the home, has been increased from $7,500 to $8,000 for a first-time purchaser of a home before December 1, 2009. The Homebuyer's Credit passed last year was only available until July 1, 2009, and was repayable over 15 years (or upon sale of the home), making it an "interest-free" 15-year loan as opposed to a true credit. ARRA waives the repayment provisions for first-time homebuyers who purchase a home after January 1, 2009, and before December 1, 2009, provided the first-time homebuyer

holds the house at least 3 years. Otherwise the credit is to be repaid to the IRS. The credit phases out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 for joint filers).

C. Section 24, Refundable child credit. Under ARRA, more families will be eligible for the additional child tax credit because of a change to the way the credit is figured. Taxpayers who cannot otherwise take full advantage of the child tax credit because the credit is more than the taxes they owe may now receive a payment for some or all of the credit not used to offset their taxes. It is a refundable credit, which means taxpayers may receive refunds even when they do not owe any tax. ARRA reduces the minimum earned income amount used to calculate the additional child tax credit to $3,000. Before ARRA, the minimum earned income amount was set to rise to $12,550. Reducing the amount to $3,000 permits more taxpayers to use the additional child tax credit and increases the amount of the payments they may receive. This change applies to tax years beginning in 2009 and 2010.

D. Section 32, Earned income credit. ARRA provides a temporary increase in the earned income tax credit ("EITC") for taxpayers with 3 or more qualifying children. The maximum EITC for this new category is $5,657. ARRA also increases the beginning point of the phaseout range for the credit for all married couples filing a joint return, regardless of the number of children. These changes apply to 2009 and 2010 tax returns. The earned income tax credit is a refundable credit intended to help people who work but earn modest incomes. The credit begins to phase out at $21,420 for married taxpayers filing a joint return with children, and completely phases out at $40,463 for 1 child; $45,295 for 2 children; and $48,279 for 3 or more children. For married taxpayers filing a joint return with no children, the credit begins to phase out at $12,470, and completely phases out at $18,440.

E. ARRA Section 2202, Government retiree credit. ARRA provides a one-time payment of $250 to many people on fixed incomes, such as Social Security recipients and disabled veterans. Similarly, it provides a one-time refundable tax credit of $250 to certain government retirees who aren't eligible for Social Security benefits. Both the $250 payment and the $250 credit reduce any allowable Making Work Pay credit.

F. Section 25A, American Opportunity Credit. Under ARRA, more parents and students will qualify for a tax credit to pay for college expenses over the next 2 years. The American Opportunity Credit is not available on the 2008 returns taxpayers are filing during 2009. The new credit modifies the existing Hope Credit for tax years 2009 and 2010, making the a similar education credit available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for 4 post-secondary education years instead of 2. Many of those eligible will qualify for the maximum annual credit of $2,500 per student.

The full credit is available to individuals whose MAGI is $80,000 ($160,000 joint filers). The credit is phased out for taxpayers with incomes above these levels.

G. Section 25C, Nonbusiness energy property credit. ARRA encourages homeowners to make their homes more energy efficient. The credit for nonbusiness energy property is increased for homeowners who make qualified energy-efficient improvements to existing homes. The law increased the rate to 30% of

the cost of all qualifying improvements and raises the maximum credit limit to a total of $1,500 for improvements placed in service in 2009 and 2010. Qualifying improvements include the addition of insulation, energy-efficient exterior windows and energy-efficient heating and air conditioning systems.

H. Section 25D, Residential energy efficient property credit. This nonrefundable energy tax credit will help individual taxpayers pay for qualified residential alternative energy equipment, such as solar hot water heaters, geothermal heat pumps and wind turbines. The law removes some of the previously imposed maximum amounts and allows for a credit equal to 30% of the cost of qualified property. The annual maximum limits applicable to the residential alternative energy credit are eliminated for solar hot water heaters, wind turbine property, and geothermal heat pumps.

I. Sections 30B, 30D, Plug-in electric drive motor vehicles. ARRA modified the credit for qualified plug-in electric drive vehicles purchased after Dec. 31, 2009. To qualify, vehicles must be newly purchased, have four or more wheels, have a gross vehicle weight rating of less than 14,000 pounds, and draw propulsion using a battery with at least 4 kilowatt-hours that can be recharged from an external source of electricity. The minimum amount of the credit for qualified plug-in electric drive vehicles is $2,500 and the credit tops out at $7,500, depending on the battery capacity. The full amount of the credit will be reduced with respect to a manufacturer's vehicles after the manufacturer has sold at least 200,000 vehicles.

J. Section 30, Plug-in electric vehicles. ARRA created a special tax credit for two types of plug-in vehicles — certain low-speed electric vehicles and 2- or 3-wheeled vehicles. The amount of the credit is 10% of the cost of the vehicle, up to a maximum credit of $2,500 for purchases made after Feb. 17, 2009, and before Jan. 1, 2012. To qualify, a vehicle must be either a low speed vehicle propelled by an electric motor that draws electricity from a battery with a capacity of 4 kilowatt-hours or more or be a 2- or 3-wheeled vehicle propelled by an electric motor that draws electricity from a battery with the capacity of 2.5 kilowatt-hours. A taxpayer may not claim this credit if the plug-in electric drive vehicle credit is allowable.

K. Sections 30B, 30C, Alternative vehicles and refueling property. ARRA modifies the credit rate and limit amounts for property placed in service in 2009 and 2010. Qualified property (other than property relating to hydrogen) is now eligible for a 50% credit, and the per-location limit increases to $50,000 for business property (and to $2,000 for other/residential locations). Property relating to hydrogen keeps the 30% rate as before, but the per-business location limit rises to $200,000.

IV. BUSINESS INCOME AND DEDUCTIONS

A. Section 108(i), Cancellation of debt income.

1. General Rule. A taxpayer can elect to defer cancellation of indebtedness income ("CODI") arising from a qualified reacquisition of certain corporate or business debt instruments issued by the taxpayer or a related person. At the election of the taxpayer, income from the discharge of indebtedness in connection with the reacquisition after December 31, 2008, and before January 1, 2011, of an applicable debt instrument is includible in gross income ratably over the 5-tax-year period beginning with: (1) The 5th tax year

following the tax year in which the reacquisition occurs for a reacquisition occurring in 2009; and (2) The 4th tax year following the tax year in which the reacquisition occurs for a reacquisition occurring in 2010.

2. Qualifying Reacquisition. Qualifying reacquisitions include:

a. The acquisition of a debt instrument for cash;

b. The exchange of a debt instrument for another debt instrument (including the modification of a debt instrument in a deemed exchange);

c. The exchange of a debt instrument for equity of the issuer;

d. The contribution of a debt instrument to the capital of the issuer by an equity owner; or

e. The complete forgiveness of a debt instrument by a holder.

3. Eligible Debt Instrument. This term is defined broadly to include (a) any indebtedness issued by a C corporation; and (b) indebtedness issued by any other person in connection with its conduct of a trade or business.

4. Making the Election. Rev. Proc. 2009-37 (reproduced at Appendix A) provides detailed guidance on the procedures that must be followed to make the Section 108(i) election. Generally, the election is made by attaching a statement meeting the requirements of the Rev. Proc. to the taxpayer's timely filed (including extensions) original federal income tax return for the taxable year in which the "reacquisition" event triggering CODI occurs. Partnerships, S corporations and certain other entities must include additional detailed information in their election statements. The Rev. Proc. also requires taxpayers who make the Section 108(i) election to maintain certain information and to include disclosure statements with their federal tax returns throughout the period that the CODI is deferred.

A pleasant surprise in Rev. Proc. 2009-37 is the lengths to which the IRS went to provide taxpayers with maximum flexibility in making the Section 108(i) election work. The IRS seems to have embraced the remedial nature of Section 108(i) in fashioning taxpayer-friendly procedures for making the election, including:

a. Automatic 12-Month Extension. The Rev. Proc. allows an automatic 12-month extension for making the Section 108(i) election.

b. Partial Elections. The Rev. Proc. provides the ability to make the Section 108(i) election with respect to only a portion of the CODI realized by the taxpayer. For example, a taxpayer who realizes $100 of CODI can elect to defer only $40 (or any other amount) of the CODI.

c. Debt-by-Debt Election. The Rev. Proc. offers flexibility, allowing the taxpayer to make different elections (including no elections) for different debt obligations that have generated CODI.

d. Protective Elections. The Rev. Proc. expressly gives taxpayers the ability to make a protective Section 108(i) election, when there may be doubt whether an event – such as the modification to the terms of an existing loan – has triggered CODI.

e. Other Guidance in Rev. Proc. 2009-37. The Rev. Proc. also resolves statutory ambiguities relating to CODI attendant to property transfers and coordinating the new subsection with Code section 752. (See Appendix A – Rev. Proc. 2009-37.)

B. Section 179(b)(7), Section 179 expensing. For small businesses, when tangible personal property is placed in service, much of the cost can be deducted up front. Under pre-ARRA law, the maximum amount that could be deducted "up front" in 2009 and 2010 was scheduled to be $133,000. After 2010, the amount that can be deducted is scheduled to be $125,000. This "up-front" deduction is reduced by the excess of the total investment is over $530,000 in 2009 or 2010; after 2010 the cap is $200,000. For 2009, ARRA increased the immediate write-off of expenses under Section 179 to $250,000 and the investment cap to $800,000.

C. Section 168(k), Bonus depreciation. A bonus depreciation deduction has been available since 2002. The 2008 stimulus package included a bonus depreciation deduction for most property placed in service (other than buildings) equal to 50% of the asset's basis. ARRA extends this 50% bonus deprecation for another year for qualified business property placed in service in 2009. (The credit is extended through 2010 for qualifying property with a longer production period.) Furthermore, this tax benefit is not added back for AMT calculations.

D. Section 1374(d)(7), S corporations. If a C corporation elects to become an S corporation, the corporation's built-in gain ("BIG") will be subject to two levels of tax if that gain is recognized during the 10 year period following the conversion. Under ARRA, the 10-year holding period is reduced to a 7-year holding period for any BIG recognized in 2009 or 2010.

E. Section 172(b), NOL carrybacks.

1. General Rule. In an effort to "smooth out" income fluctuations from the down economy, eligible small businesses can elect to use an extended 3-, 4-, or 5-year carryback period for 2008 net operating losses (NOLs).

2. Eligible Business. An eligible small business is defined as a corporation, partnership or sole proprietorship that meets a $15 million gross receipts test for the tax year in which the loss arose.

3. Gross Receipts Test. The gross receipts test looks at the taxpayer's prior 3 tax years to determine its average gross receipts. If the average is less than $15 million, the business qualifies for the extended carryback. Note that for purposes of this gross receipts test, all of the businesses in which an individual taxpayer owns more than a 50% interest are aggregated. The IRS has recently issued Rev. Proc.

2009-19, to clarify an ambiguity in the statute regarding which 3 years are tested, holding that the 3-year lookback includes the 2008 year.

a. Fiscal Year Taxpayers. Fiscal year taxpayers are permitted to choose between their tax year beginning in 2008 and their tax year ending in 2008.

F. ARRA Section 1261, Bank acquisitions.

1. Code Section 382. Section 382 protects against loss trafficking by barring an investor from achieving a greater benefit, through acquisition of a company with loss carryovers, than would be obtainable from an investment in tax-exempt securities. Absent the section 382 limitations, investors would use the acquired losses to offset their taxable income.

2. IRS Notice 2008-83. In October of 2008, the Treasury issued Notice 2008-83, making section 382 limitations on loss carryovers (including any deduction for a reasonable addition to a reserve for bad debts) in change of ownership circumstances inapplicable to banks. This resulted in debates over whether the Notice conflicted with the legislative intent of section 382, and whether the Treasury has the authority to provide exemptions or special rules restricted to particular industries or classes of taxpayers.

3. Legislative Repeal of Notice 2008. Section 1261 of ARRA revoked Notice 2008-83 on a prospective basis for transactions consummated on or after January 16, 2009, with an exception for transactions for which a binding contract was in existence as of January 16, 2009. ARRA also declared that (1) issuing the Notice was inconsistent with the Congressional intent behind Section 382(m); (2) the legal authority to prescribe the Notice was doubtful; and (3) the Secretary of the Treasury was not authorized under section 382(m) to provide exemptions or special rules restricted to particular industries or classes of taxpayers. ARRA permits banks to rely upon Notice 2008-83 for federal income tax purposes in the case of transactions consummated before January 16, 2009.

G. Section 382(n), Corporate restructurings. ARRA clarified the application of the Section 382 limitation on the use of net operating losses by corporations that have undertaken restructurings that are within the scope of the Emergency Economic Stabilization Act of 2008 (the "EESA"). In general, restructurings that are within the scope of the EESA include modifications to an organization's capital structure and business operations implemented to achieve long-term financial viability and competitiveness.

ARRA makes it clear that the Section 382 limitation does not apply when the ownership change is pursuant to a restructuring plan of the taxpayer which (1) is required under a loan agreement or a commitment for a line of credit that is within the scope of the EESA and (2) is intended to result in a rationalization of the costs, capitalization, and capacity with respect to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries. Thus, a corporate taxpayer meeting both prongs of the exception may utilize its pre-change net operating losses against its post-change income without applying the Section 382 limitation. The exception, however, does not apply to a subsequent ownership change that does not fall within ARRA provisions. In addition, the ARRA exception does not apply if any person owns 50% or

more of the corporation immediately after the ownership change. Finally, the ARRA exception does not modify any other operative rules under Section 382.

H. Section 163, Corporate OID. For certain high-yield OID obligations, the yield is divided into an interest component that is deductible only when paid and a return on equity component that is not deductible as interest but may entitle the holder to a dividend received deduction. ARRA suspends these rules for obligations issued in a debt for debt exchange that occurs on or after September 1, 2008, and before January 1, 2010. The rules are not changed for new issuances of debt for cash.

I. Sections 265(b) and 291(e), Exempt interest expenses. Generally, banks and other financial institutions are denied an interest deduction in proportion to the ratio of their tax-exempt bond holdings to their total assets. However, 80% of a bank's interest expense allocable to carrying qualified tax-exempt obligations (bank qualified bonds) is deductible. ARRA extends to banks an administrative safe-harbor rule currently applicable to other taxpayers by permitting banks to deduct 80% of the interest allocable to carrying tax-exempt obligations issued in 2009 and 2010 to the extent those obligations don't exceed 2% of the bank's assets. For this purpose, refunding bonds are treated as issued when the refunded bonds were issued or, for a series of refundings, when the original bonds were issued. In addition, ARRA increases from $10 million to $30 million the annual amount of bonds an issuer can designate as bank-qualified bonds for bonds issued in 2009 and 2010. For this purpose, ARRA provides that qualified 501(c)(3) bonds are treated as issued by the 501(c)(3) borrower organization for whose benefit the bonds are issued, rather than by the actual issuer of the bonds, and that, in certain circumstances involving pooled or composite issues, the annual limitation is applied at the borrower rather than issuer level. These bank qualification changes should increase the potential investor pool for tax-exempt bonds and possibly lower the cost of capital for issuers/borrowers.

J. ARRA Section 7001, TARP limits on executive pay.

1. Background. ARRA significantly expanded the executive compensation requirements previously imposed under the EESA, which established the Troubled Assets Relief Program ("TARP"). ARRA's executive compensation restrictions apply to any entity that has received or will receive financial assistance under TARP (a "TARP recipient"), and generally will continue to apply for as long as any obligation arising from financial assistance provided under TARP remains outstanding (the "TARP assistance period"). The TARP assistance period does not include any period during which the federal government only holds warrants to purchase a TARP recipient's common stock.

2. Tax Provisions. The ARRA restrictions on the use of TARP funds are complex and go beyond the scope of this discussion. For tax purposes, practitioners need only be aware that each TARP Recipient is subject to the $500,000 compensation deduction limitation of Section 162(m)(5). Because this Code provision is premised on government acquisitions of assets rather than government stock purchases, it is not clear how it will apply, if at all, to TARP recipients.

K. ARRA Section 7024, Withholding on government contracts. Under prior law, governmental entities were to have begun withholding 3% on payments made to government contractors on January 1,

2011. The withholding rule requirements have been delayed under ARRA, and now apply to payments made after December 31, 2011.

L. Section 6654(d), Individual estimated tax payments. For certain individuals with qualified small business income, estimated tax payments for tax years beginning in 2009 may be based on 90% of the prior year's tax liability.

M. ARRA Section 704, Large corporation's estimated tax payments. Corporations with at least $1 billion in assets must increase their estimated tax payments for July, August and September of 2013 to 120.25% of the amount otherwise due.

V. BUSINESS-RELATED TAX CREDITS

A. Sections 168(k) and 6211(b), Accelerated credits. A corporation that elects to claim an accelerated alternative minimum tax credit or research credit in lieu of bonus depreciation may increase its credit limitation by the amount of bonus depreciation claimed with respect to certain extension property placed in service in 2009.

B. Sections 25C(a), 25D(b), 48, 48A(b) and 48B(b), Energy credit. The energy credit is modified with respect to small wind energy property and subsidized energy financing or industrial development bonds. Taxpayers can elect to claim the energy credit portion of the investment tax credit in lieu of the production tax credit for certain qualified energy production facilities.

C. Section 45(d), Renewable electricity production credit. Section 45 generally allows a credit, known as the "PTC", based on the amount of electricity sold to an unrelated taxpayer that is produced at a qualified renewable energy facility over a 10-year period beginning on the date the facility is placed in service. Over the 10 years, the owners of the qualified facilities are able to offset these federal taxes due with the credits generated from the sale of this electricity. To qualify for the "PTC, the facility must be placed in service before a specified statutory date. ARRA extends the placed-in-service date for qualified wind facilities placed in service before January 1, 2013, and for qualified facilities placed in service before January 1, 2014, in the case of other renewable sources. By allowing the placed-in-service date to be extended, Congress has given developers more time to seek financing for various renewable energy projects that may have been stalled due to the current credit crunch and down-turn in the economy.

D. Section 48, Renewable energy credit or grant.

1. Credit.

a. Background. Section 48 provides a purchaser of qualified solar property a credit equal to 30% of the cost of the property purchased ("ITC"). Typically, commercial solar projects are owned through investment partnerships where investors are allocated the beneficial credit that they can utilize on federal tax returns leaving the developers as the effective operator of the energy property.

b. ARRA. ARRA added an important provision allowing taxpayers an irrevocable election to claim the ITC in lieu of the PTC.

c. Benefits. This may be a significant boost to wind developers who have stalled projects for two reasons. First, it allows these developers to provide a higher degree of certainty of cash return since the ITC is based on initial cost instead of the variable PTC. Secondly, the ITC provides a more immediate benefit since it is claimed in the first year the property is placed in service, unlike the PTC which is based on electricity production over a 10-year period. Wind developers, however, must carefully analyze the effects of making the election as they may still prefer to claim the PTC.

There may also be a secondary benefit to other renewable energy producers, such as biomass facilities, since they are only allowed half of a PTC credit under the current rules. This new provision may allow these developers to pass through a larger credit and essentially provide more tax equity for their projects.

2. Grant in Lieu of Credit. Importantly, ARRA adds a new provision authorizing the Secretary to provide grants in lieu of the PTC or ITC for certain property placed in service in 2009 and 2010. To obtain a grant in lieu of the PTC or ITC, taxpayers must file an application with the Treasury before October 1, 2011. Depending on the type of equipment purchased and placed into service, the grant is equal to either 30% or 10% of the tax basis in tangible property used as an integral part of a qualified facility. The requirements for qualifying for the grant are intended to mirror those of the ITC with grant recipients excluding the amount of the credit from their gross income.

In the past, financial institutions were purchasers of PTCs and ITCs, effectively providing much of the equity funding for these projects. The recent economic downturn among financial institutions has caused much of the tax credit market to dissipate. This new provision has the potential to jump start a number of renewable energy projects by providing refundable credits, precluding the need to rely on the tax credit market to fund these projects.

E. Sections 46, 48C and 49, Qualifying advanced energy project credit. ARRA establishes a new investment tax credit for qualified tangible personal property placed in service at manufacturing facilities which are “qualifying advanced energy projects.” The federal credit is equal to 30% of qualified property placed in service. A qualifying advanced energy project is a project which re-equips, expands or establishes a manufacturing facility for the production of property that is used in the production of certain renewable energy, advanced battery technology, property used in electric grids to support and store renewable energy, and certain other property used in green technologies.

Unlike the ITC and PTC, taxpayers must receive a certification from the IRS that they have a qualifying advanced energy project before they claim the credit on their returns. Although the Treasury has 180 days from enactment to draft regulations on the grant application process, developers would be well advised to start the application process early as funds are limited, and the application process will likely be competitive.

F. Section 45D(f), New markets credit. Section 45D provides taxpayers with a new market credit equal to a percentage of the amount paid to a qualified community development entity for a qualified equity investment. A qualified equity investment is a cash investment in a qualified community development entity (as defined by the Code) that is used to make qualified low-income community investments. Before enactment of ARRA, the new markets tax credit was available through 2009, subject to a national $3.5 billion limitation. ARRA increased the limitation to $5 billion for 2008 and 2009.

G. Section 42(i) and ARRA Section 1602, Low-income housing grants. States may elect to receive federal grants in exchange for a portion of their unused low-income housing credit allocations for 2008 and 2009. The states must use the grants to make subawards to finance low-income housing.

H. Section 51(d), Work opportunity credit. Prior to ARRA, a tax credit was available to employers who electively hire individuals from one or more of nine targeted groups. The amount of credit available to the employer was dependent upon the amount of qualified wages paid by the employer. ARRA extended this credit and two new categories of employees that qualify for the credit: unemployed veterans and disconnected youth who begin work for the employer in 2009 or 2010, provided the job starts after December 31, 2008. ("Disconnected youth" is generally defined as individuals between the ages of 16 and 24 who are not in school and not legitimately employed.)

I. Section 45Q, Carbon dioxide sequestration credit. ARRA amends the carbon dioxide sequestration credit, which was added to the Code by the EESA. The $10-per metric ton credit for carbon dioxide that is used as an injectant in certain enhanced oil or natural gas recovery projects is now available only if the carbon dioxide is disposed of in secure geological storage.

PART II – THE OBAMA ADMINISTRATION'S TAX PROPOSALS

I. INTRODUCTION

The tax proposals to President Obama's 2010 budget are summarized in his administration's "Greenbook", published by the Treasury in May of this year. The Administration's budget assumes a baseline in which the 2001-2003 tax cuts are permanent and the exemption to the AMT is permanently indexed for inflation from its 2009 level. These provisions would cost the Treasury about $3.3 trillion of revenue over 2009-2019. The revenue loss is much more considerable, however, considering that the 2001-2003 tax cuts were set to expire in 2011. Most of the changes are not indexed for inflation, so some of the proposed tax cuts would benefit fewer taxpayers as time goes on.

II. TAX CUTS FOR FAMILIES AND INDIVIDUALS

The first items outlined in the Administration's "original" tax plan/budget involve use of tax credits and deductions to put more spending money in taxpayers' pockets, focused in particular on providing such incentives to lower-income individual taxpayers. In large part, the Administration would extend the Bush tax

cuts (set to expire in 2011); ensure that certain credits remain available to taxpayers by making some temporary credits permanent; adjust inflation indexing (as lower incomes have not risen at the same rate as the general population); and increase income phaseouts or reduce the phaseout rate. The Greenbook proposal would extend or otherwise modify the following credits:

A. The "Making Work Pay" Credit: Up to a $400 ($800 for joint filers) credit to taxpayers earning less than $75,000 per year ($150,000 for joint filers). Set to expire in 2010, the Administration's proposal would make this credit permanent.

B. Earned Income Tax Credit: The EITC phases out for joint filers at a level $5,000 higher than for single filers, but this increase is set to expire in 2011. The Greenbook proposal would make permanent this $5,000 increase for joint filers.

C. Child Tax Credit: Since the wages of low income families have not kept up with inflation, the Greenbook proposal would remove indexing of the $3,000 earnings threshold, which would presumably make the credit available to more taxpayers in the future. The Administration's proposal would also make permanent the $3,000 threshold, which is set to revert to $10,000 (indexed) in 2011 under current law.

D. Saver's Credit: The Administration proposes to extend the Saver's Credit, which currently provides a credit up to $1,000 ($2,000 for joint filers) to taxpayers who contribute to a retirement savings plan. Qualifying taxpayers include joint filers with less than $55,500 of income, heads of household with less than $41,625 of income, and single filers with less than $27,750 of income; the credit is nonrefundable. The proposal would make the credit refundable to taxpayers and would reconfigure the 50% credit up to $500 per individual (indexed for inflation). Effectively, the government would pay up to half the cost of the first $1,000 deposited to an IRA or 401(k) account for an eligible household.

E. Automatic IRA and 401(k) Enrollment: To encourage long-term saving by taxpayers, the Administration proposes to establish an automatic enrollment procedure into IRAs and 401(k)s whereby employers in business at least 2 years and with 10 or more workers will be required to automatically place its workers in a workplace pension plan unless the worker opts out. Employers without a retirement plan would have to enroll employees in a direct-deposit IRA unless the worker opts out. In essence, the proposal would change opting into the retirement plan as the default rather than opting out as the default (as it is under current law). The Administration research indicates that this will markedly increase worker participation in retirement plans, anticipating an increase from 15% to 80% of participating workers.

F. American Opportunity Tax Credit: The American Opportunity Tax Credit replaced the Hope credit under ARRA. For students enrolled at least half-time in postsecondary education, the AOTC is a partially refundable tax credit of 100% of the first $2,000, plus 25% of the next $2,000 spent on tuition, fees and course materials for the first 4 years of enrollment. The credit phases out between $160,000 and $180,000 ($80,000 to $90,000 for single filers). This credit is longer (4 years versus 2) and larger than the Hope credit and the thresholds would be indexed for inflation. The Administration's proposal would make this credit permanent.

III. TAX CUTS FOR BUSINESS

A. Eliminate Capital Gains Taxation on Investments in Small Business Stock. The Administration proposes to increase the exclusion ratio for gains on the sale of certain small business stock held for five or more years ("QSBS" – see page 1) and have that portion taxed at a preferential rate (28%). ARRA increased the exclusion from 50% to 75% for stock acquired in 2009 and 2010. The Administration would increase this to a 100% exclusion for all small-business stock issued after February 17, 2009. The purpose is to encourage and reward new investment.

B. Make the Research & Experimentation ("R&E") Tax Credit Permanent. The R&E credit expires each year and must be reenacted each year. The Greenbook proposal would make the R&E credit permanent to avoid uncertainty about its availability in the future and to provide businesses with security that they will be receiving the continued benefit of the credit in future years, promoting continued research and experimentation.

C. Expand Net Operating Loss ("NOL") Carryback. The Greenbook is unspecific in this regard, stating, "The Administration looks forward to working with Congress to make a lengthened NOL carryback period available to more taxpayers." ARRA permitted a 5-year carryback for losses incurred in tax years beginning or ending in 2008 (as opposed to 2 years for other years' NOLs). The ARRA provisions impose a number of constraints that limit the extended carryback period for certain taxpayers (generally, higher-income taxpayers). The Administration sees continuing some kind of extended carryback as a means to "smooth out swings in business income" and to provide qualifying taxpayers with additional funds with which they might fund capital investment or other operating expenses.

IV. "LOOPHOLE" CLOSERS

A. Tax Carried (Profit) Interests as Ordinary Income. The taxation of carried interests is something that seems to be introduced into Congress regularly but has yet to be passed or even considered in any significant sense. Under current law, a partner who receives a profits interest in exchange for services (such profits interest being referred to as a "carried interest") characterizes his, her or its distributable share of partnership income in the same manner as does the partnership/the other partners. The Administration is promoting a change whereby all partnership income allocable to a carried interest would be characterized as ordinary, irrespective of its character to the partnership/the other partners. The policy underlying this proposed change is to reflect the concept that the income and gain recognition allocable to the carried interest are attributable to the services rendered by the partner holding the carried interest, and not as a result of his, her or its investment (i.e. the carried interest is, in essence, compensation, not a return on investment).

The scope of this proposal could be broad. Last year, a similar bill before Congress (not passed) would have applied the rule to virtually all carried interest partners, even though the chief motivation for the change is in the fund management arena, where managers typically receive a profits interest but are essentially

entitled to capital gains treatment for services. The Greenbook is not specific as to whom the new provisions might apply, but ostensibly, the rule would apply to all carried interest partners, irrespective of the partnership's activities.

The same concerns could conceivably be addressed by taxing the receipt of the carried interest as ordinary income and then allowing the carried interest partner to characterize his share of partnership income consistent with the partnership's characterization (which would be more "in accord" with current law. Congress has balked at such a move for fear of the difficulties is valuing a pure profits interest.

B. Codify "Economic Substance" Doctrine. Codification of the economic substance doctrine is another perennial favorite in Congress (that never seems to be passed); which the Administration has proposed once again. The Administration believes that codification of the judicial doctrine along with increasing the penalty for tax positions lacking economic substance would deter tax-avoidance transactions.

The Administration proposes a rule whereby a transaction would satisfy the economic substance doctrine only if (i) it changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position; and (ii) the taxpayer has a substantial purpose (other than a federal income tax purpose) for entering into the transaction. The proposal would enable the Treasury to promulgate regulations to carry out the purposes of the proposal. Many opponents are resistant to a legislative definition because it may add little to already-established judicial precedent and could potentially provide a roadmap for taxpayers to design transactions that satisfy the doctrine.

C. New Understatement Penalty. As part of its proposal to codify economic substance, the Administration has also proposed a 30% penalty on an understatement of tax attributable to a transaction lacking economic substance, reduced to 20% if the position is adequately disclosed on the tax return. The penalty would generally replace the other understatement penalties, although the amount of the "economic substance understatement" would be considered in determining whether a taxpayer's total understatement is "substantial" under Code section 6662.

D. Repeal the Last-In, First-Out ("LIFO") Method of Accounting for Inventories. Many businesses hold inventories of goods and products for sale. Because the purchase of inventory represents an exchange of cash for an equal value of assets, firms cannot deduct inventory when purchased. Instead, firms deduct the cost of inventory against the sale of goods in computing net profit. Because otherwise identical goods moving out of inventory can have different costs, depending on when they were acquired, firms rely on specific conventions to account for the costs of goods sold.

Most companies use first-in-first-out (FIFO), which assumes that the goods first purchased are the ones first sold. The cost of the goods on hand at the end of the year (the firm's inventory), reflects the most recent purchases. Alternatively, companies can elect to use last-in-first-out (LIFO) as long as they use the same method for financial statement purposes. This method assumes that the goods first purchased make up the firm's inventory at the close of the year. If prices are rising, LIFO allocates higher costs to goods sold, which both reduces current income and assigns a lower value to the year-end inventory.

The Administration, which sees the LIFO method of accounting as a means of deferring income (based on the assumption that inventory costs increase over time), would repeal the election to use LIFO for income tax purposes. Taxpayers that currently use the LIFO method would be required to write up – that is, revalue – their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. This one time increase in gross income would be taken into account ratably over the first taxable year and the following 7 taxable years.

The Greenbook notes that international reporting standards and that the SEC may be adopting such a rule. If it does, then companies subject to federal securities law would have an impermissible book/tax disparity, which is not permitted under the LIFO rules (you can only use LIFO for tax purposes if you use the same method for financial statement purposes).

V. INTERNATIONAL TAX REFORMS

The Administration has proposed a number of reforms to international tax law. Some of the more significant proposals are outlined below:

A. Tighten Collection and Enforcement of Sheltering Income Offshore. The Administration's goal is to tighten enforcement of tax laws to limit offshore tax evasion. During his campaign, President Obama promised to make it more difficult for individuals to use foreign "tax havens" to avoid US taxes. The Administration's proposal would follow through on this promise by detailing collection measures to combat tax evasion by those who use offshore accounts to shelter income from US taxation. The provisions would raise approximately $8.7 billion from 2010 to 2019. They would require more information reporting, increase withholding, and strengthen penalties as a deterrent to sheltering income. Provisions affected by this proposal would include the following:

1. Foreign "Qualified Intermediaries".

a. Current Law. Foreign financial institutions may contract with the IRS to operate according to a set of withholding and reporting rules under the "qualified intermediary" (QI) program. QIs collect identifying information from their customers, file withholding tax returns and information returns, and submit to periodic audits performed by external auditors supervised by IRS examiners. QIs need not assume primary reporting and withholding responsibility with respect to accounts held by US persons. The problem perceived by the Administration centers around the situation of a financial institution that is part of a controlled group. One member of the controlled group may contract to be a QI while other members do not. Thus, accounts and clients may be divided between commonly-controlled QI and non-QI institutions.

b. Proposal. Foreign entities would not be qualified as QIs unless all the entity's account holders are US persons. A QI would be required to report all reportable payments received on behalf of all US account holders. Any withholding agent making a payment of "FDAP" income to a nonqualified intermediary would be required to withhold at a rate of 30%. Similarly, withholding agents making a payment

of gross proceeds from the sale of any security of a type that would be reported to a US non-exempt payee nonqualified foreign intermediaries would be required to withhold 20% of the gross proceeds.

2. Reporting Transfers to Foreign Financial Accounts. The Administration has proposed, in addition to the Treasury's FBAR requirements, that any transfers of money or property by a US individual to or from any foreign bank, brokerage, or other financial account by the individual or by any entity which the individual owns (actually or constructively) more than 50% ownership. Transfers to or from accounts managed by QIs would be exempt, as would individuals whose cumulative transfers did not exceed $10,000 in a given year.

3. Disclosure of FBAR Accounts on Tax Return. In a similar vein to the foregoing, the Administration would require individuals to report to the IRS the fact that s/he is required to file an FBAR (even though the FBAR is due to the Treasury Department at a later date in the year). The proposal would not alter the taxpayer's obligation to file the FBAR to the Treasury Department.

4. Third Party Information Reporting. In addition to taxpayers' FBAR filing obligation and the other reporting requirements outlined above, the Administration proposes that any US financial intermediary or QI to report such transfers as well. Similarly, any US person or QI that forms or acquires a foreign entity on behalf of a US individual or on behalf of an entity in which a US person owns at least a 50% interest would be required to file an information return with the IRS regarding the foreign entity formed or acquired.

5. Double Accuracy-Related Penalties. The Administration proposes to double the understatement penalty (from 20% to 40%) when an understatement arises from a transaction involving a foreign account that the taxpayer failed to disclose their FBAR-related information on their tax return.

B. Foreign Business Entity Classification Rules.

1. Current Law. Foreign entities are currently permitted to "check-the-box" for classification of foreign entities for tax purposes. While the check-the-box regulations were targeted at domestic businesses, they also allowed companies to create hybrid entities which were treated as a corporation in one country and as an unincorporated branch in another. Check-the-box allows US multinational companies to lower taxes in high-tax countries by shifting income from affiliates in those countries to affiliates in tax havens.

2. Example. A typical scenario would involve the contribution of capital by a US corporation to a wholly-owned foreign affiliate in a tax haven. A second affiliate is organized as a subsidiary, checking the box as an unincorporated branch but recognized as a corporation in the second country. The second affiliate's interest payments are deductible in its country of residence, but both affiliates are treated as one branch for US tax purposes. Since the first affiliate is not taxed on interest and since US tax law disregards the affiliates, the interest expense is allowed as a deduction but never taxed anywhere.

3. Proposal. The Administration proposes to impose US tax on the interest payment by making sure that the hybrid entity remains "visible" for US tax purposes.

C. Expenses Related to Deferred Income. Under current law, companies with overseas operations may immediately deduct expenses supporting foreign investment while deferring payment of taxes on profits from those investments until they repatriate the profits. Under the Administration's proposal, companies could not claim deductions on their US tax returns for expenses supporting their foreign investments (except for R&E expenses) until they pay US taxes on their foreign earnings. The provision would effectively limit the benefit of deferral by raising the cost of delaying US tax payments on foreign profits.

D. Reform Foreign Tax Credit. The Administration proposes to limit cross-crediting by requiring firms to consider the foreign tax they pay on all their foreign earnings and profits in determining their foreign tax credits. Under current law, the foreign tax credit is based on earnings for foreign taxes paid on deferred income until they repatriate that income. The provision would limit firms' ability to blend their repatriations to minimize or avoid US taxes on foreign source income. This proposal would also increase the cost of deferral.

The Administration also proposes to curb methods companies use to inappropriately separate creditable foreign taxes from the associated foreign income. Details are lacking, but the proposal presumably would target arrangements in which foreign tax credits are claimed by US companies on income not subject to a US tax.

E. Repeal 80/20 Company Rules. Currently, dividends and interest paid by a domestic corporation are generally US-source income to the recipient and subject to gross basis withholding tax if paid to a foreign person. An exception exists where at least 80% of the corporation's gross income during a 3-year testing period is foreign source and attributable to the active conduct of a foreign trade or business. The Administration believes this exception is easily manipulated and would repeal it.

VI. ELIMINATE OIL AND GAS COMPANY PREFERENCES

The Administration's proposes to eliminate $31.5 billion in oil and gas company preferences over a decade. The plan includes a "new excise tax on offshore oil and gas production in the Gulf of Mexico to close loopholes that have given oil companies excessive royalty relief." The new tax would begin in 2011, which the document says is "after the economy has had time to recover," and the budget assumes it would bring in nearly $5.3 billion over a decade. The Administration also proposes to repeal a number of tax credits specifically designed for the oil and gas industry. Also potentially on the chopping block is the exemption of oil and gas properties from the passive loss rules.

VII. TAX INCREASES TO HIGH-INCOME TAXPAYERS

Nearly all of President Bush's 2001 and 2003 tax cuts are set to expire in 2011, returning individual income tax to its pre-2001 levels. The Greenbook proposal's budget analysis assumes as its baseline that

these changes would remain permanent. Presumably, then, with the exception of the changes listed below, the Administration would keep the Bush tax cuts intact. Relative to current law, under which the 2001-2003 cuts would expire after 2010, these proposals would increase income taxes for about 5% of taxpayers, with the greatest increase at the upper-end of income distribution. About 1/6th of those in the top 25% and 1/4th of those in the top 1% would experience a tax increase.

A. Tax Rates. The Administration would let the 2001 tax rates revert to their pre-2001 levels for high-income taxpayers. The proposal would increase the tax rate for the highest bracket to 39.6% from 35% (from 2011 forward). The Administration also proposes to increase the income tax rate for the second-highest bracket from 33% to 36% but would increase the "floor" income threshold for this bracket from $210,400 to $232,950 (for joint filers). So, even though the rate is increased, some taxpayers will see their marginal rate drop from 33% to 28%.

B. Itemized Deduction and Personal Exemption Phaseout. High-income taxpayers face limitations on their personal exemptions and itemized deductions. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA 2001") phased out limitations on itemized deductions and personal exemptions beginning in 2006, with complete elimination of the limitations in 2010. The limitations are to revert to their previous (2005) levels after 2010. The Administration proposes to allow the phaseouts to expire and to reinstate the limitations in 2011.

1. Itemized Deductions. Prior to the enactment of EGTRRA, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) were reduced by 3% of the amount by which AGI exceeded a statutory floor that was indexed annually for inflation, but not by more than 80% of the otherwise allowable deductions. For 2010, the reduction was to be completely eliminated (allowing high income earners to claim their itemized deductions in full). However, beginning in 2011, the full limitation (3% of AGI exceeding the floor) is scheduled to be reinstated. For 2009, the AGI floor is $166,800 ($83,400 if married filing separately).

a. Proposal. The Administration would permanently extend the EGTRRA repeal of the elimination of the limitation on itemized deductions. Thus, itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) would be reduced by 3% of the amount by which AGI exceeds statutory floors (which are higher than under current law), but not by more than 80% of the otherwise allowable deductions. The floors would be indexed annually for inflation. For 2011, the AGI floors would be adjusted for inflation starting with 2009 values of $250,000 for married taxpayers filing jointly, and $200,000 for single taxpayers.

2. The Personal Exemption Phase-Out ("PEP"). Individual taxpayers generally are entitled to a personal exemption for themselves and for each of their dependents. The amount of each personal exemption is $3,650 for 2009, which amount is indexed annually for inflation.

Prior to the enactment of EGTRRA, all personal exemptions were reduced or completely phased out for higher-income taxpayers. For a taxpayer with AGI in excess of the threshold amount for the taxpayer's filing

status, the amount of each personal exemption was reduced by 2% of the exemption amount for that year for each $2,500 ($1,250 if married filing separately) or fraction thereof by which AGI exceeded that threshold. EGTRRA reduced the otherwise applicable limitations on claiming personal exemptions by one-third for 2006 and 2007, by two-thirds for 2008 and 2009, and by 100% (completely eliminating the limitation) for 2010. However, beginning in 2011, the full personal exemption phase-out is scheduled to be reinstated.

a. Proposal. The Administration would permanently extend the EGTRRA repeal of the personal exemption phase-out (thereby requiring exemptions to be phased out. The AGI levels at which the phase-out begins would be adjusted. For 2011, the AGI floors would be adjusted for inflation starting with a 2009 values of $250,000 for married taxpayers filing jointly ($125,000 if filing separately) and $200,000 for single taxpayers.

C. Dividends and Capital Gains. Historically, dividends had been taxed at ordinary income rates and capital gains taxed at a lower rate. Under current law, the maximum rate of tax on the adjusted net capital gain of an individual is 15%. In addition, any adjusted net capital gain otherwise taxed at a 10 or 15% rate is taxed at a zero-percent rate. These rates apply for purposes of both the regular tax and the AMT. Qualified dividends generally are taxed at the same rate as capital gains.

The 0 and 15% rates for dividends and capital gains are scheduled to sunset for taxable years beginning after December 31, 2010. In 2011, the maximum rate on capital gains would increase to 20%, while the tax rates for dividends would go back to the higher ordinary tax rates of up to 39.6%.

The Administration would permanently extend the 0 and 15% tax rates for dividends and capital gains. The 0 and 15% tax rates for capital gains and qualified dividends would be extended permanently for taxpayers with incomes up to $250,000 for joint returns and $200,000 for single taxpayers. The 20% tax rate on long-term capital gains and qualified dividends would apply for married taxpayers filing jointly with income over $250,000 less the standard deduction and two personal exemptions (indexed from 2009) and for single taxpayers with income over $200,000 less the standard deduction and one personal exemption (indexed from 2009). The reduced rates on gains on assets held over 5 years would be repealed.

D. Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability.

1. Proposal. The Administration proposes to limit the value of deductions to no more than 28% beginning in 2011. The limit would increase taxes for those in the 33% and 35% tax brackets. Combined with the effects of the limitation on itemized deductions (discussed above), these proposals would limit the tax savings from itemizable expenses to as little as 5.6% of those expenses, compared to the 39.6% maximum tax savings that a taxpayer in that bracket would have had without any of the Administration's changes.

a. Chilling Effects on Expenditures. This change could have a chilling effect on some expenditures, to the extent those expenditures are tax motivated. For example, under the 2010 tax regime, where there are no limits on itemized deductions, an individual's charitable donation would provide a tax benefit equal to 35% of the amount donated. Thus, a $10,000 donation would provide the taxpayer with a

$3,500 reduction in tax for a total outlay of $6,500. By contrast, to achieve the same $6,500 net expenditure under the Administration's proposal, assuming the worst case scenario of a 5.6% tax benefit, the taxpayer would only contribute $6,886. In effect, the government has taken a $3,114 benefit ($10,000 less $6,886) away from the charity because of the donor's income level.

The proposal would presumably affect a taxpayer's choice of housing insofar as mortgage interest payments would be similarly limited.

2. Alternatives Considered. President Obama's Advisory Panel on Federal Tax Reform proposed an interesting alternative to the Greenbook proposal. It proposed to replace itemized deductions with a 15% credit on most itemizable expenditures. That change would give all taxpayers the same tax savings for a given deductible expenditure, severing the connection between tax rates and the value of deductions. It would recognize the public value attached to particular expenditures but remove those expenditures from the determination of ability to pay.

VIII. ESTATE AND GIFT TAX

A. HR 436. On January 9, 2009, HR 436 was introduced in the House. The bill is currently before the House Ways and Means Committee. The bill addresses the sunsetting of the estate tax and issues of valuation discounts.

1. Estate Tax Exclusion & Rate. The bill would strike the sunset provision[2] and continue the $3.5 million estate tax exclusion. The bill would also cap the top estate tax rate at 45% (down from 50%).

2. Valuation Reforms.

a. Proposal. Perhaps more disconcerting to taxpayers and estate planners is the Administration's call to curb valuation discounts for estate and gift tax purposes. The bill would eliminate the perceived abuses of family limited partnerships ("FLPs") and similar entities by recharacterizing the transfer of an interest in any non-"actively traded" entity as a transfer of any "nonbusiness assets" held by the entity. Further, the nonbusiness assets are to be valued without application of any valuation discount.

The proposed new Code 2031(d)(2) defines "nonbusiness assets" as assets not used in the active conduct of trade or business.

A "lookthrough" rule applies where the entity owns a 10% or greater ownership interest in another entity as a nonbusiness asset.

b. Speakers' Comments. The bill (HR 436) is built upon the presumption that there is no reason other than estate tax avoidance for the formation of a non-actively traded entity that does not carry on a trade or business. But in many cases, the most important reason for forming these entities is not tax reduction but the proper allocation (i.e., division among owners) and management of assets. The courts

have recognized that families create closely-held entities (e.g., limited partnerships, limited liability companies, and corporations (both subchapter S and subchapter C)) for a variety of non-tax reasons including: (1) to increase asset protection; (2) to reduce family disputes concerning the management of assets; (3) to prevent the undesired transfer of a family member's interests due to a failed marriage; and (4) to provide flexibility in business planning. In many instances, these closely-held entities are created for estates that are not taxable for estate tax purposes; thus, discounts for these estates are not the motivating factor in creating the closely-held entity.

B. Greenbook Proposals. The Administration has proposed a number of changes to the estate and gift tax.

1. Consistency between Transfer and Income Tax Valuations. The Administration proposes to ensure consistency between transfer and income tax valuation and basis principles by enacting legislation requiring that the basis of property in the hands of a recipient shall be no greater than the value of that property as determined for estate and gift tax purposes. The executor or donor would be required to report the necessary information to the recipient and to the IRS. The Treasury would be given regulatory authority to provide for the appropriate procedures and forms for this purpose.

2. Disregarded Restrictions on FLP Interests. Section 2704(b) currently provides that certain "applicable restrictions" that would normally justify valuation discounts are to be ignored in valuing interests in family-controlled entities if those interests are transferred to or for the benefit of other family members. The Administration proposes to create an additional category of disregarded restrictions under Code section 2704(b). Specifically, a transferred interest in an FLP would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in the regulations. Also included as a disregarded restriction is any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity.

3. Minimum Term for GRATs. Grantor retained annuity trusts ("GRATs") have proven to be a popular technique for transferring wealth while minimizing the tax cost of such transfers, provided the grantor survives the GRAT term and the assets do not depreciate in value. A popular strategy is to use a very short GRAT term (2 years is a popular choice) and retain an annuity interest significant enough to reduce the gift tax value of the remainder to zero or a very small number.

The Administration proposes to curb what it perceives as a problem with the GRAT rules by requiring a minimum 10-year GRAT term. This solution would not necessarily eliminate the zeroing out of gift tax value for the remainder, but it would increase the risk of a grantor dying prior to the end of the GRAT term, resulting in the loss of an anticipated transfer tax benefit.

IX. TAX ADMINISTRATION

A. Revise Offer-In-Compromise Application Rules. Current law requires taxpayers to make a nonrefundable payment of 20% of any Offer-in-Compromise ("OIC"). The Administration feels that the OIC program should be made available to more taxpayers and has proposed to eliminate the requirements that an initial OIC include a nonrefundable payment of any portion of the taxpayer's offer. The Administration believes that the elimination of the down payment would also make it easier for the Treasury to obtain the collectible portion of existing tax liabilities by making the program available to more taxpayers.

B. Make Repeated Willful Failures to File a Tax Return a Felony. In an effort to enforce compliance with our self-reporting system of taxation, the Administration would like to tighten the consequences of a failure to file a tax return. Currently, a willful failure to file is a misdemeanor punishable by imprisonment for not more than 1 year, a fine of not more than $25,000 ($100,000 for a corporation), or both.

The Greenbook proposal would augment this consequence by providing that a taxpayer who willfully fails to file in any 3 of a consecutive 5-year period (for aggregated tax liability of $50,000 or more) would be committing a felony, punishable by a fine of not more than $250,000 ($500,000 for a corporation), imprisonment of not more than 5 years, or both.

C. Expand Required Electronic Filing by Tax Return Preparers. Electronic filing is seen as beneficial because it decreases processing errors, expedites processing and payment of refunds, and allows the IRS to efficiently maintain up-to-date records. Currently, persons filing at least 250 tax returns during the calendar year are required to file electronically, but under the enabling statute, the Regulations cannot require individuals, estates or trusts to file electronically.

The proposal would expand this to also require any electronic return preparer filing at least 100 returns per year to file all returns electronically. Moreover, the proposal would allow the Regulations to require return preparers who file more than 100 returns (or any other person who files more than 250 returns) to file electronic tax returns for individuals, estates or trusts.

X. LEGISLATIVE UPDATE

A. Health Care Reform. Prior to its summer recess, House Ways and Means approved a tax title to the America's Affordable Health Choices Act of 2009, which would offset the bill's cost by imposing an income surtax, beginning in 2011. The surtax, which would raise $544 billion over 10 years, would be:

- 1% of modified adjusted gross incomes ("MAGI," which is AGI less investment interest) of $350,000 to $500,000 for married taxpayers filing joint returns
- 1.5% on MAGI of $500,000 to $1 million
- 5.4% on MAGI of more than $1 million

The amounts to which the surtax would apply to married persons filing separate returns would be 50% of that of joint filers, and to all other taxpayers, 80%.

The bill's would also :

- Delay the implementation of worldwide allocation of interest for purposes of determining the limitation on the foreign tax credit from tax years beginning after 2010 to tax years beginning after 2019
- Limit income tax treaty benefits for certain deductible payments made to foreign subsidiaries of foreign parent corporations located in third countries
- Codify the economic substance doctrine (previously discussed)
- Modify the penalties on understatements attributable to transactions lacking economic substance

In the Senate, Finance Committee negotiators were reportedly considering a tax on insurance providers with respect to high-priced policies.

B. Energy. In June, the House approved the American Clean Energy Security Act (ACES). Its most prominent feature is a greenhouse gas emissions limitation and trading scheme known as cap and trade. Under ACES, the government would limit emissions in the U.S. economy by giving or auctioning emissions permits, known as allowances. Companies could buy and sell allowances directly or through an exchange. ACES does not contain a title describing the tax consequences of the multi-billion dollar carbon market it creates.

The Senate is considering its own cap-and-trade proposal. The Finance Committee held hearings to explore the taxation of emission allowances, generally, and focused on three themes: (1) whether to treat the grant of allowances as taxable income; (2) how to prevent the allowance process from being tax-inefficient for users of allowances; and (3) how to address the taxation of allowances to market participants, such as funds and traders, that do not use allowances.

The Senate is not expected to turn its attention to ACES until after it completes action on health care reform.

C. Executive Compensation. Following public concern over bonuses paid to employees of companies that received TARP funds, the House approved H.R. 1586, which would impose additional tax on bonuses received by individuals from certain TARP recipients. The 90% tax on bonuses would apply to bonuses paid after 2008 by companies that receive more than $5 billion in TARP funds. The bill would not affect taxpayers with adjusted gross income below $250,000.

Senate Finance Committee leaders countered by proposing S. 615, which would impose a 35% excise tax on all bonuses of employees of TARP recipients in which the federal government holds an equity interest, including Fannie Mae and Freddie Mac. The tax would apply to both the employer and the employee.

No further action has been taken.

D. Treatment of Stock Options. The Ending Excessive Corporate Deductions for Stock Options Act would, among other things, limit the corporate deduction for stock option compensation to the amount reported for financial accounting purposes.

The bill would allow corporations to deduct stock option compensation in the year it is reported for financial accounting purposes; require use of the same-book stock option deduction for purposes of computing "wages" eligible for the research tax credit; and make corporate executive stock options part of the $1 million cap under section 162(m) on corporate deductions that applies to other types of compensation to top executives of publicly held corporations.

E. Corporate Management and Control. The Stop Tax Haven Abuse Act would make a number of reporting, penalty, and enforcement changes with respect to offshore accounts, transactions and entities, based in part on a list of 34 “offshore secrecy jurisdictions.”

Among its provisions, the bill would treat foreign corporations managed and controlled in the United States as domestic corporations for tax purposes. The bill would authorize Treasury to prescribe regulations to determine whether the management and control of a corporation is to be treated as occurring primarily within the United States. The regulations would provide that management and control is primarily within the U.S. if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the United States. The regulations also would define U.S. management and control if the assets of the corporation (directly or indirectly) consist primarily of assets being managed on behalf of investors, and decisions about how to invest the assets are made in the United States.

F. Pay/Go Budgeting. The term “pay/go” describes procedures of both the House and Senate under which, as applied to tax provisions, any bill that increases the deficit or reduces the surplus, when measured over certain defined time periods, is out of order. This means that procedural hurdles must be overcome unless a tax bill is revenue neutral over the measuring periods. In the House, as a practical matter, pay/go may be waived by a simple majority vote, although its waiver has political consequences. In the Senate, however, 60 votes are required to overcome a point of order, which any senator may raise.

With the Administration’s support, the House passed H.R. 2920, the Statutory Pay-As-You-Go Act of 2009, in July.

In the House, the Pay-As-You-Go Act would require offsets for all tax legislation that is estimated to lose revenue compared to a baseline of current law. Recognizing White House priorities, the Pay-As-You-Go Act would exempt from its requirements the extension of certain "current policies"—the 2001 and 2003 tax cuts for all but the top two income tax brackets; elements of the current capital gains and dividends rates; 2009 estate tax rates and exemption levels; annual inflation adjustment for the alternative minimum tax exemption; expanded child care credit; marriage penalty relief; adoption, dependent care and employer provided child care credits; and the education tax benefits enacted in 2001 and thereafter. JCT estimates the cost of extending these "policies" compared to present law at $2.5 trillion.

Any legislation considered after enactment of statutory pay/go would be subject to the rules. Thus, it could affect the substance and prospects of extending the expiring provisions.

G. Expiring Provisions / Alternative Minimum Tax / Estate Tax / Revenue Offsets. Forty-six tax provisions—most prominently the research and experimentation tax credit, Subpart F active financing exception and CFC look-through rule—expire at the end of 2009. Congress has routinely extended and, on occasion, expanded these provisions, generally shortly before their expiration and occasionally after. The cost of extending these provisions for one year is more than $25 billion.

Since the enactment of the 2001 and 2003 individual income tax rate cuts, Congress has also annually enacted an increased alternative minimum tax (AMT) exemption designed to keep the number of AMT filers at its pre-2001 levels (the "AMT Patch"). A one-year extension and inflation adjustment will cost at least $70-$80 billion.

Under current law, the estate tax is repealed at the end of 2009, and reinstated in 2011 at its pre-2001 levels of a $1 million exemption level and a 55% maximum rate. The Administration proposes making permanent the 2009 maximum rate and exemption levels of 45% and $3.5 million. That would cost $233 billion over the 10-year budgeting period, as measured against the baseline of current law.

Congress has not considered the expiring provisions, a 2010 AMT extension, or the estate tax, nor indicated when it will. One issue that will have to be resolved is the extent to which the pay/go rules will apply. The House pay/go legislation would exempt the alternative minimum tax and estate tax extensions from the pay/go regime. That indicates that even if the pay/go legislation is not enacted, it may be possible to consider the AMT and estate tax extensions in the House without revenue offsets. A point of order will still lie in the Senate, and 60 votes would be necessary to overrule it if raised, but the Senate has shown little interest in offsetting the cost of extending the AMT extension in recent years.

The remaining expiring provisions pose a more difficult issue. Neither the administration nor any member of Congress has voiced support to date for enacting these provisions without revenue offsets. Thus, even if statutory pay/go is not enacted, revenue neutrality may be required if the expiring provisions are taken up this year. One potential revenue offset—which raises approximately the needed amount and passed the House last year—is the provision to treat the return on a carried interest as ordinary income.

H. The Long View of the Budget. The current year deficit is projected to be $1.7 trillion, or about 12% of Gross Domestic Product ("GDP"). The Congressional Budget Office ("CBO") projects that, if the Administration's budget is enacted, the 10-year deficit will be $9.1 trillion, with annual deficits at levels after 2012 in excess of 5% of GDP. With the federal debt continuing to grow much faster than the economy, rising costs for health care and the aging of the U.S. population, federal spending is projected to increase rapidly. Unless revenues increase just as rapidly, the rise in spending will produce growing budget deficits and accumulating debt. This situation has prompted commentators to (again) suggest that a value added tax ("VAT")—will be needed to close the revenue gap. A VAT of 15% to 20% would essentially close the fiscal gap, assuming the enactment of the tax provisions and spending provisions in the Administration's budget.

I. The Outlook for this Fall. The outcomes of the health care and energy initiatives are unclear. It seems clear, however, that health care reform will include tax increases to offset costs, but it is unknown whether those increases will be confined to "health-related" tax provisions, as the Senate is considering, or expanded to some version of the income surtaxes the Ways and Means Committee has reported.

Congress will have to address the AMT, estate tax and other expiring provisions eventually, either later this year or early next.[3] The potential need to find revenue offsets for, in particular, the expiring provisions complicates that effort.

While it is unlikely that many (any?) of the President's business tax proposals will be taken up this year, some of them could be used to fund health care reform.

The next most likely tax reform, if any (this year), would probably involve pensions/retirement savings, either in the form of relief for plans and/or some kind of changes with respect to fees charged of 401(k) enrollees.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

[2] Under current law, the estate tax is effectively repealed in 2010, even though it then goes back into existence at its pre-EGTRRA levels in 2011.

[3] Some question exists as to whether Congress can retroactively reinstate the estate tax. As it is currently set for repeal in 2010, there is some incentive for Congress to act on it this year (2009).