

White House proposes \$2.2 trillion tax hike for business, high-income individuals

President Barack Obama released a 10-year, \$3.8 trillion FY 2011 budget proposal February 1 that continues the populist tone he adopted in his recent State of the Union address and expands the tax principles he has espoused since the 2008 presidential election campaign: tax breaks for working families and small businesses, tax increases for upper-income individuals and corporations, reform of international tax rules, an end to tax preferences for large oil and gas companies, and closing of perceived corporate loopholes.

In all, the budget package provides for \$381 billion in tax relief and \$2.2 trillion in revenue-raising provisions.

For lower- and middle-income individuals, the president once again proposes to make permanent the Bush-era tax cuts that are scheduled to expire at the end of this year. He also delivered on a set of new tax relief proposals announced January 25 that would, among other things, extend the Making Work Pay Credit, increase the Child and Dependent Care Tax Credit, increase the child care tax credit, and expand and simplify the Savers Credit.

To ease the tax burden on small businesses, the administration would extend the increased section 179 expensing limit and eliminate capital gains taxation on investment in small business stock.

Businesses generally would be able to take advantage of proposals to make the research credit permanent, extend temporary bonus depreciation, and extend and modify the New Markets Tax Credit. The administration also would extend for two years a number of popular temporary business tax incentives such as the subpart F exception for active financing income and the lookthrough exception for controlled foreign corporations, and 15-year depreciation for qualified leasehold improvements and qualified restaurant property.

To offset the cost of proposed tax relief – as well as reduce the deficit, finance the wars in Iraq and Afghanistan, and pay for health care reform – the president, as expected, has recycled a number of the significant revenue offsets from last year's budget and added some new ones. Among the highlights:

- **Modifications to the international tax rules** – The budget once again includes proposals to modify the foreign tax credit and deferral rules, limit earnings stripping by expatriated entities, prevent repatriation of earnings in certain cross-border reorganizations, repeal the 80/20 company rules, and repeal the dual-capacity rules. Notably, however, *the administration has dropped a proposal from last year that would reform the business entity classification ("check-the-box") rules for foreign entities.*
- **Tougher rules for financial institutions and products** – The budget includes a new proposal unveiled by the administration in January that would impose a "fiscal crisis responsibility fee" on large financial institutions to recoup the cost of the Troubled Asset Relief Program (TARP). It also brings back proposals from last year intended to close certain perceived loopholes for financial institutions and insurance companies.
- **Elimination of fossil fuel tax preferences** – The budget carries over provisions from last year that would reinstate superfund taxes, but drops a provision from last year that called for taxing outer continental shelf oil and gas production. As it did last year, the budget would repeal oil and gas company tax preferences; but it adds several new provisions that would repeal coal company preferences. A new provision would make black liquor ineligible for the cellulosic biofuel producer credit.
- **Information reporting and compliance provisions** – As it did last year, the budget would expand information reporting rules in ways that would not just track income, but also flag potential areas of taxpayer noncompliance. A significant new proposal would permit the Internal Revenue Service to issue guidance relating to the proper classification of workers and allow the IRS to reclassify certain workers who it believes are currently misclassified and whose reclassification is prohibited under current rules.
- **Changes to tax treatment of carried interests** – The budget once again proposes to tax income from carried interests as ordinary income.
- **Tax increases on high-income individuals** – As it did last year, the budget would, among other provisions, reinstate the 39.6 percent tax rate, limit the itemized deductions for high-income taxpayers, allow the 2001 and 2003 tax cuts to expire for families earning over \$250,000 a year, and modify the estate and gift tax valuation discount rules.

International tax reform proposals

The administration once again has proposed major changes to international tax rules. However, it has dropped some of last year's proposals – such as the controversial check-the-box rule changes – tweaked other proposals, and added new ones. While the international changes would raise less revenue than last year's package, the current proposals would still raise more than \$122 billion over 10 years.

Deferral – The administration proposes restricting the ability of companies to take current deductions for interest expenses that are allocated and apportioned to foreign-source income that is not currently subject to U.S. tax. However, it would not include other expenses, such as general and administrative, as in last year's budget proposal.

According to the explanation provided by the Treasury Department, the allocation and apportionment would be determined under current regulations. Because it would limit interest expense deductions, the proposal could have a significant impact on capital-intensive or highly leveraged industries, such as construction, heavy manufacturing, and financial services.

The administration's proposal would be effective beginning in 2011 and is estimated to raise more than \$25 billion from 2011-2020.

Foreign tax credits – Claiming that the reduction in tax credit baskets to two has enhanced taxpayers' ability to reduce U.S. taxes on foreign-source income through cross-crediting, the administration again proposes requiring taxpayers to determine their deemed-paid foreign tax credits on a consolidated basis. The taxpayer would have to calculate aggregate foreign taxes and earnings and profits of all foreign subsidiaries (including lower-tier subsidiaries) for which the taxpayer can claim a deemed foreign tax credit, and the deemed foreign tax credit would then be calculated on the basis of the amount of the consolidated earnings and profits of the foreign subs that is repatriated to the taxpayer in the current taxable year.

The administration also claims that current law allows taxpayers to inappropriately separate "creditable foreign taxes from the associated foreign income in certain cases such as those involving hybrid arrangements." In response, the administration proposes the adoption of a matching rule that would prevent the separation of foreign taxes from associated income. According to the Treasury explanation, the proposal would allow a credit for foreign taxes "when and to the extent the associated foreign income is subject to U.S. tax in the hands of the taxpayer claiming the credit."

The two tax credit proposals would be effective in 2011 and would raise more than \$59 billion from 2011-2020.

Intangible property transfers – The administration has proposed two provisions that would affect intangible property transfers because of what the administration views as opportunities to use the transfer pricing rules to avoid U.S. tax.

Under the first proposal, if a U.S. person transfers an intangible to a related controlled foreign corporation that is subject to a low foreign effective tax rate in circumstances that demonstrate excessive income shifting, then the part equal to the "excessive return" would be treated as subpart F income in a separate foreign tax credit limitation basket.

This new proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise more than \$15 billion by 2020.

In the second which is repropounded from last year, the administration proposes to clarify the definition of intangible property to include workforce in place, goodwill, and going concern value. For transfers of multiple intangible properties, the commissioner would have the option of valuing the intangible properties on an aggregate basis to achieve a more reliable result. The proposal also provides that the commissioner may value intangible property by taking into consideration "the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken."

The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise \$1.2 billion from 2011-2020.

Reinsurance – Current law generally allows insurers a deduction for premiums paid for reinsurance. In addition, reinsurance policies issued by foreign insurers covering U.S. risks are generally subject to an excise tax equal to 1 percent of the premiums paid, unless waived by treaty. The administration believes that these rules provide improper tax advantages and

create incentives for foreign-owned domestic insurers to reinsure U.S. risks with foreign affiliates in a way that would not occur between unrelated parties at arm's length.

The administration proposes to deny U.S. nonlife insurance companies a deduction for certain excess nontaxed reinsurance premiums paid to affiliates. The proposal would not allow deductions to the extent that the foreign reinsurers or their parents are not subject to U.S. tax with respect to the premiums received, and the amount of reinsurance premiums (net of ceding commissions) paid to the reinsurers exceeds 50 percent of the total direct premiums received by the U.S. insurer and its U.S. affiliates for a line of business. For premiums that would be denied a deduction, a foreign company could elect to treat those premiums as effectively connected with the conduct of a trade or business in the United States.

This proposal appears similar to a bill (H.R. 3424) introduced last July by House Ways and Means Committee member Richard Neal, D-Mass.

The proposal, which was not included in last year's budget, would be effective for taxable years beginning after December 31, 2010, and is estimated to raise \$519 million over 10 years.

Earnings stripping – The proposal would tighten section 163(j) and limit the deductibility of interest paid by “expatriated entities” to related persons. Expatriated entities would be defined by applying section 7874 and its regulations as if they were in effect beginning July 10, 1989, but the definition would not include surrogate foreign corporations that are treated as domestic companies under section 7874. For expatriated entities, the current debt-to-equity safe harbor would be eliminated, and the 50 percent adjusted taxable income threshold for the limitation would be reduced to 25 percent of adjusted taxable income for disqualified interest. The carryforward for disallowed interest would be limited to 10 years, and the carryforward of excess limitation would be eliminated.

The current proposal makes one change from last year: it does not allow the 50 percent adjusted taxable income threshold to continue for interest on related-party guaranteed debt.

The proposal would be effective beginning in 2011 and would raise almost \$3.6 billion by 2020.

“80/20 company” rules – Dividends and interest paid by a domestic corporation are generally considered U.S.-source income and subject to withholding tax if paid to a foreign person. An exception to this rule applies when a domestic corporation derives at least 80 percent of its gross income from an active foreign business (an “80/20 company”).

In that context, the dividends and interest paid by the 80/20 company are treated as foreign-source, and not subject to U.S. withholding tax. The administration believes that the 80/20 company provisions are subject to manipulation and has proposed their repeal.

The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise \$1.1 billion from 2011-2020.

Equity swaps – The administration proposes that income earned by foreign persons on equity swaps that reference U.S. stock be treated as U.S.-source to the extent that income is attributed to or calculated by reference to dividends paid by a domestic corporation.

The proposal would apply to payments made after December 31, 2010, and it is estimated to raise \$1.2 billion by 2020.

Tax rules for dual-capacity taxpayers – Taxpayers that are subject to a foreign levy and also receive a specific economic benefit from the levying country (so-called “dual-capacity” taxpayers) may not claim a foreign tax credit for the portion of the foreign levy paid for the specific economic benefit. Under Treasury regulations, if a foreign country has a generally imposed income tax, then a dual-capacity taxpayer may credit the portion of the levy in the amount of what the generally imposed income tax would be.

For dual-capacity taxpayers, the administration's proposal would allow the taxpayer to treat as a creditable tax that portion of a foreign levy that does not exceed the foreign levy the taxpayer would pay if it were not a dual-capacity taxpayer. The administration also proposes replacing the current regulatory provisions, including the safe harbor, on the determination of what amount of a foreign levy paid by a dual-capacity taxpayer qualifies as a creditable tax.

Further, the proposal would also convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. Lastly, the proposal would yield to U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise \$8.5 billion from 2011-2020.

Combat underreporting of income through use of offshore accounts and entities

The administration is proposing a series of measures to strengthen the information reporting and withholding systems that support U.S. taxation of income earned or held through offshore accounts or entities, in an effort to crack down on taxpayers that “hide” assets in foreign bank accounts, trusts, or corporations. The measures proposed this year focus largely on increased reporting and increased penalties. These measures combined are estimated to raise \$5.4 billion over 10 years.

Many of these proposals are similar to ones approved by the House late last year as part a tax extenders package.

Increased reporting on foreign accounts – The proposal would require a withholding agent to withhold tax on payments to a foreign financial institution (FFI) of U.S.-source fixed or determinable annual or periodic (FDAP) income and gross proceeds from the sale of any property of a type that can produce U.S.-source interest or dividends, unless the FFI has entered into a qualified intermediary (QI) agreement with the IRS. The FFI would be required to identify accounts held by specified U.S. persons or by foreign entities in which a specified U.S. person owns, directly or indirectly, an interest of more than 10 percent. The FFI generally would be required to report the name, address, and taxpayer identification number (TIN) of the covered account holder, the account balance or value, and the gross receipts and gross withdrawals or payments from the account.

This proposal would not apply to a payment if the beneficial owner is a foreign government, an international organization, a foreign central bank, or any other class of persons that Treasury concludes presents a low risk of tax evasion. Foreign beneficial owners of payments that are subjected to withholding tax in excess of their income tax liability would be permitted to apply for a refund of any excess. The proposal would be effective beginning after December 31, 2012.

Increased reporting of FDAP income and gross proceeds – Under this proposal, any withholding agent making a payment of U.S.-source FDAP income and gross proceeds from the sale of any property of a type that can produce U.S.-source interest or dividends to a foreign entity (other than an FFI) would be required to withhold tax at the rate of 30 percent, unless the foreign entity (1) certifies that no U.S. person owns, directly or indirectly, an interest of more than 10 percent or (2) discloses the name, address, and TIN of each such substantial U.S. owner, and the withholding agent does not know or have reason to know that any information provided is incorrect. Exceptions would be provided for payments to publicly traded companies and their subsidiaries, foreign governments, international organizations, foreign central banks, any 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 such possession, and other classes of person or payment identified by Treasury as posing a low risk of tax evasion. The proposal would be effective for payments made after December 31, 2012.

Registered bond requirements – The proposal would eliminate foreign-targeted exceptions to the bond registration requirements in an effort to ensure that the owners are identified and the income from such obligations properly reported. The provision would be effective for obligations issued after the date which is two years after the date of enactment.

Disclosing foreign accounts on tax return – Augmenting the disclosure required in a Report of Foreign Bank and Financial Accounts (FBAR), the proposal would require the disclosure of more detailed information regarding foreign financial assets on the income tax return. The proposal would apply to any U.S. individual who holds an interest in a foreign financial account, an interest in a foreign entity, or any financial instrument or contract held for investment and issued by a foreign person if the aggregate value of all such assets exceeds \$50,000. Penalties for failing to report the foreign financial asset would be consistent with current penalties for failing to disclose an interest in a foreign entity – i.e., \$10,000 – unless the failure is shown to be due to reasonable cause and not willful neglect. The Secretary would be given regulatory authority to apply the proposal to certain domestic entities formed or availed of for purposes of holding foreign financial assets.

A rebuttable evidentiary presumption would apply in a civil administrative or judicial proceeding (and not criminal proceedings) providing that, if it is established that the individual had an interest in an undisclosed foreign financial asset,

then the aggregate value of all foreign financial assets in which a U.S. individual has an interest will be presumed to exceed \$50,000. This proposal would not alter the FBAR reporting requirements or penalties for failure to file an FBAR.

The proposal would be effective for taxable years beginning after the date of enactment.

Reporting of certain transfers of assets to or from foreign financial accounts – The proposal would require increased information reporting with respect to transfers to and from certain foreign accounts. A U.S. individual would be required to report, on the individual's income tax return, any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual, but only if the cumulative amount or value of transfers, and the cumulative amount or value of receipts that would otherwise be reportable for a given year, were each \$50,000 or more. The same requirement would apply to any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest.

The Treasury Department would receive regulatory authority to require the reporting of additional information and to provide exceptions to the reporting requirement, such as an exception for arm's-length payments in the ordinary course of business for services or tangible property. The penalty for failure to report a covered transfer would equal the lesser of \$10,000 per reportable transfer or 10 percent of the cumulative amount or value of the unreported covered transfers, unless due to reasonable cause. The proposal would be effective for transfers made after 2012.

Third-party information reporting – U.S. financial institutions would face additional reporting requirements for transactions that establish foreign accounts or transfer assets to and from foreign financial accounts on behalf of U.S. individuals, or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest. Exceptions would apply for certain types of entities, such as publicly traded corporations. The proposal would apply to transfers of money or property with an aggregate value of more than \$50,000. Failure would be subject to penalty, unless due to reasonable cause.

The proposal would be effective for amounts transferred and accounts opened beginning after 2012.

Electronic filing by financial institutions – The proposal would permit Treasury to issue regulations requiring electronic filing for any return filed by a financial institution with respect to any taxes withheld by the financial institution. The proposal would apply to returns due after the date of enactment (determined without regard to extensions).

Presumption of U.S. beneficiary in case of transfers to foreign trusts by a U.S. person – The proposal would impose a presumption that a foreign trust receiving a transfer of property, directly or indirectly, from a U.S. person has a U.S. beneficiary for purposes of the grantor trust rules, unless the transferor provides sufficient information with respect to the existence of U.S. beneficiaries. The presumption would not apply transfers to certain deferred compensation and charitable trusts. This proposal would be effective for transfers of property made after the date of enactment.

Uncompensated uses of foreign trust property treated as a distribution to U.S. grantor or beneficiary – Under the proposal, if a foreign trust permits the use of trust property other than cash or marketable securities by a U.S. grantor or beneficiary (or a related U.S. person), the fair market value of such use would be treated as a distribution to the U.S. grantor or beneficiary, unless the trust is compensated. In addition, a loan of cash or marketable securities or the use of other property of a foreign trust would be treated as paid or accumulated for the benefit of a U.S. person, unless the U.S. person repays the loan or pays the fair market value of the use. This proposal would be effective for loans made, and uses of property, after the date of enactment.

Double accuracy-related penalties, extend statute of limitations – The proposal would double the section 6662 penalties when a taxpayer fails to disclose foreign financial accounts, improve the foreign trust reporting penalty, and extend the statute of limitations from three to six years for omissions from gross income of more than \$5,000 attributable to one or more foreign financial assets that were required to be disclosed.

Economic substance codification

As it did last year, the president's budget would clarify that a transaction satisfies the economic substance doctrine only if:

- It changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position and
- The taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction.

A transaction would not be treated as having economic substance solely by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction.

The proposal would impose a 30 percent penalty on an understatement of tax attributable to a transaction that lacks economic substance (20 percent if there is adequate disclosure on the taxpayer's return). This penalty would be in lieu of – not in addition to – other accuracy-related penalties that might be levied with respect to a tax understatement. The proposal does not specify whether the penalty would be a "strict liability" penalty or whether the penalty could be avoided as a result of good faith. It would allow the IRS to assert the penalty without any court determination that the economic substance doctrine was relevant, and it would allow the IRS to abate the penalty in proportion to the abatement of the underlying tax liability.

Finally, the proposal would deny any deduction for interest attributable to an understatement of tax arising from the application of the economic substance doctrine. The proposal would apply to transactions entered into after the date of enactment, and would raise \$4 billion over 10 years.

The House and Senate have attempted several times in recent years to codify the economic substance doctrine, but the legislation has never been enacted.

Carried interests

The budget repeats a proposal from last year to tax carried interests as ordinary income. In addition, the partner receiving a carried interest would be required to pay self-employment taxes on that income, and gain recognized on the sale of such an interest would be taxed as ordinary income.

The proposal would apply to "services partnership interests" (SPIs), which it defines as "a carried interest held by a person who provides services to the partnership." The proposal would not recharacterize gain to the extent that the partner who holds an SPI contributes "invested capital" and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest. Nor would the proposal recharacterize the portion of any gain recognized on the sale of an SPI that is attributable to the invested capital. The proposal defines "invested capital" as money or other property contributed to the partnership; it excludes any contributed capital that is attributable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership.

In addition, the proposal would tax at ordinary rates any income or gain received with respect to a "disqualified interest" by a person who holds that interest in an entity and performs services for it. A disqualified interest is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity, but it does not include a partnership interest or stock in certain taxable corporations.

The proposal would provide relief for real estate investment trusts (REITs), stating that it "is not intended to adversely impact qualification" of a REIT owning a carried interest in a real estate partnership. It would become effective in 2011 and is estimated to raise just under \$24 billion through 2020.

Tax accounting methods

The administration also proposes three changes to tax accounting rules:

- **Repeal LIFO** – The proposal would not allow the use of the last-in, first out (LIFO) inventory accounting method for federal income tax purposes. Taxpayers that currently use the LIFO method would be required to write up their beginning LIFO inventory to its first-in, first out value in the first taxable year beginning after December 31, 2011. However, this one-time increase in gross income would be taken into account ratably over 10 years, beginning with the first taxable year beginning after December 31, 2011. The provision would raise nearly \$59.1 billion over 10 years.

- **Repeal lower-of-cost-or-market accounting** – The proposal would prohibit the use of the lower-of-cost-or-market and subnormal goods methods resulting in a change in the method of accounting for inventories. Any resulting 481(a) adjustment would be included in income ratably over the four-year period beginning in the year of the change. The provision would raise \$7.5 billion over 10 years.
- **Punitive damages** – This proposal would disallow all deductions for punitive damages paid or incurred by a taxpayer on judgment or by settlement of a claim. It would also extend to punitive damages covered by insurance. The damages paid or incurred by the insurer would be included in the insured's gross income, and the insurer would be required to report the payment to the insured and the IRS. The proposal would apply to punitive damages paid or incurred after December 31, 2011, and would raise \$307 million over 10 years.

Financial services

In addition to reproposing several provisions from last year's budget that would affect financial services firms, the administration has included a new fee on large companies.

Financial Crisis Responsibility Fee – As announced last month, the administration proposes to impose a fee of 15 basis points (0.15 percent) on the covered liabilities of financial firms that hold assets in excess of \$50 billion. Covered firms would include banks, thrifts, bank holding companies, insurers, brokers, securities dealers, and other companies that own or control a depository entity. Covered liabilities would be assets less tier 1 capital, assessable deposits, and insurance policy reserves.

The fee would begin July 1, 2010, and continue for at least 10 years to offset the cost of TARP. The fee would apply firms that meet the asset test, whether or not they received TARP assistance. The proposal would raise \$90 billion over 10 years.

Financial institutions and instruments – The administration has recycled three provisions that would affect financial institutions and financial instruments and raise about \$3.3 billion by 2020.

- **Forward stock sales** – Currently, a company must recognize interest income on the current sale of its own stock for a deferred payment. However, a company does not recognize interest income on the forward sale of its own stock – the future issue of stock in exchange for a future payment. The administration sees no economic difference between the two situations and would align their tax treatment by requiring a corporation that enters into a forward contract to issue its stock to treat a portion of the payment as interest. The proposal would be effective for forward contracts entered into after December 31, 2011.
- **Ordinary treatment for dealers** – Current law allows commodities dealers, commodities derivatives dealers, dealers in securities, and options dealers to treat the income from certain day-to-day dealer activities as capital gain, and treat 60 percent of this income (or loss) as long-term capital gain and 40 percent as short-term capital gain. The administration proposes ending this treatment altogether and taxing dealers' income from day-to-day dealing activities at ordinary rates. The proposal would be effective for taxable years beginning after the date of enactment.
- **Control** – If a company repurchases a debt instrument that is convertible into its stock or into the stock of a corporation it controls or is controlled by, current law may disallow or limit the issuer's deduction for the premium paid to repurchase the instrument. To determine control, section 249 references the control test of section 368(c). The administration says this rule applies only to direct relationships such as a parent and a wholly owned, first-tier subsidiary and is unnecessarily restrictive. Instead, the administration proposes that the definition of control in section 249(b)(2) be amended to reference section 1563(a)(1), which the administration says would incorporate indirect control relationships, such as a parent and a second-tier subsidiary. This proposal would be effective on the date of enactment.

Insurance companies – The 2011 budget also brings back several provisions that would affect insurance companies and introduces a new proposal regarding nonqualified annuity contracts. These proposals would raise \$14.4 billion by 2020.

- **Sales of life insurance contracts** – The administration proposes new information reporting on life insurance settlement transactions – where the insured sells a previously issued policy to investors – because it is concerned about compliance issues raised by these transactions. The administration is also concerned that current-law exceptions to the transfer-for-value rule may give buyers of life policies the ability to structure a transaction to avoid paying tax when the insured dies. The administration's proposal would require anyone who purchases an

interest in an existing life insurance contract with a death benefit of \$500,000 or more (down from a proposed \$1 million last year) to report the purchase price, the buyer's and the seller's TINs, and the issuer and policy number to the IRS, to the insurance company that issued the contract, and to the seller. The proposal would also require that on the payment of any policy benefits to the buyer, the insurance company would be required to report the benefit payment, the buyer's TIN, and the insurer's estimate of the buyer's basis to the IRS and to the payee. The proposal would apply to the sale or assignment of interests in life insurance policies and the payment of death benefits beginning in 2011.

- **DRD for separate accounts** – Current law limits the dividends-received deduction (DRD) for dividends received from other domestic corporations by life insurance companies. The DRD is limited to the company's share of the dividends received (versus the share that funds reserves for obligations to policyholders) based on a proration formula. For separate accounts, the company's share and the policyholders' share is calculated separately for each separate account. The administration believes that current proration methods used by some taxpayers may inappropriately inflate the company's share for income earned by its separate account assets. The administration proposes changing the proration method to one that it says would produce the company's share of a separate account "that would approximate the ratio of the mean of the surplus attributable to the account to the mean of the account's assets." This proposal would be effective beginning in 2011.
- **COLI** – Section 264(f) disallows deductions for portions of a business taxpayer's interest that is allocable to "unborrowed cash policy values" of corporate-owned life insurance (COLI), but there is an exception for policies covering the lives of certain employees, officers, directors, and owners. The administration believes this exception allows companies to engage in tax arbitrage and proposes to repeal the exception for employees, officers, and directors, other than 20-percent owners of a business that is the owner or beneficiary of the policy. The proposal would apply to contracts issued after December 31, 2010. Material increases in the death benefit or other material changes to the contract would be treated as a new contract, and the addition of covered lives would be treated as a new contract for those additional covered lives.
- **Nonqualified annuities** – The administration notes that current law does not address the treatment of a partial annuitization, in which an annuity contract holder irrevocably elects to apply a portion of the contract to purchase a stream of annuity payments, while the remainder of the contract accumulates tax-deferred income. To encourage taxpayers to annuitize existing deferred annuity contracts, the administration proposes taxing partial annuitizations on a proportionate basis, applying an exclusion ratio. This treatment would be available only if: the taxpayer irrevocably elects to apply a portion of the contract to purchase a stream of annuity payments; that stream will last for at least 10 years or for the life of one or more individuals; and the exclusion ratio is calculated based on the expected return and investment in the contract with respect to the portion of the contract that is annuitized. The proposal would be effective for partial annuitizations after December 31, 2010.

Energy provisions

Credit for advanced energy manufacturing projects – The budget proposal would add \$5 billion to the \$2.3 billion that is allocated to the Advanced Energy Investment Credit and modify the requirements for the credit.

This new 30 percent credit was created by the American Recovery and Reinvestment Act of 2009 (ARRA) to encourage investments in facilities that manufacture advanced energy property. It is available for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy, through a competitive bidding process. Advanced energy property includes technology for the production of renewable energy, energy storage, energy conservation, efficient transmission and distribution of electricity, and carbon capture and sequestration. In addition to providing more funds for the credit, the administration proposes to modify the requirements for the credit so that it can apply to part of a taxpayer's qualified investment in a project.

Revenue raisers – On the revenue side, the budget proposal calls for eliminating numerous current-law tax preferences that promote oil and gas production. Similar measures were included in last year's budget. These changes would be effective beginning in 2011 and are expected to generate nearly \$37 billion in revenue over 10 years.

- **Repeal the section 199 deduction for oil and gas companies** – The administration's proposal would repeal the 6 percent domestic production activities deduction for oil and gas companies.
- **Repeal the passive loss exception for working interests in oil and gas companies** – Under current law, the passive activity loss rules, which limit the ability of taxpayers to deduct certain losses, are not applicable to working interests in oil or gas property that a taxpayer holds directly or indirectly through an entity that does not limit the

taxpayer's liability with respect to the interest. Repealing this exclusion would make it more difficult for small and medium-sized companies to attract investors and to obtain the capital needed to fund exploration projects.

- **Repeal incentives for exploration** – Current tax incentives for domestic exploration and drilling would be eliminated. These include: (1) 24-month amortization for geological and geophysical costs for independent oil and gas producers; (2) the enhanced oil recovery credit; (3) the marginal well tax credit; (4) the deduction for tertiary injectant expenses; (5) expensing of intangible drilling costs (IDCs) and 60-month amortization of capitalized IDCs; and (6) percentage depletion for oil and gas wells.
- **Repeal incentives for energy production from coal mining activities** – The budget proposal also includes new measures that would repeal current tax incentives for energy production from coal mining activities starting in 2011 and would raise more than \$2 billion in revenue over 10 years. They would eliminate: (1) the section 199 domestic manufacturing deduction from the production of coal and other hard mineral fossil fuels; (2) expensing and 60-month amortization of mining exploration and development costs relating to coal and other hard mineral fossil fuels; (3) capital gain treatment of coal and lignite royalties; and (4) percentage depletion with respect to coal and other hard mineral fossil fuels.
- **Reinstate superfund taxes** – As it did last year, the administration proposes to raise \$19 billion over 10 years by reinstating taxes that were originally enacted in 1980 to finance the cost of cleaning up toxic waste sites and allowed to expire in 1995. The superfund taxes included: (1) an excise tax of 9.7 cents per barrel on crude oil received at a U.S. refinery and on each barrel of imported petroleum products; (2) an excise tax of varying amounts on certain hazardous chemicals sold in the United States or used in substances imported into the United States; and (3) an environmental tax of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded \$2 million. These taxes would be reinstated for tax years beginning in 2011 and sunset after 2020.
- **Make “black liquor” mixtures ineligible for production credit** – The administration proposes to make black liquor mixtures used as fuel in paper processing ineligible for the cellulosic biofuel producer credit. Black liquor is a liquid byproduct of a method used to produce wood pulp in the paper industry. This measure would raise \$24 billion in revenue and be effective on the date of enactment.

One of the revenue measures missing from this year's budget is a proposal to tax outer continental shelf (OCS) oil and gas production. In last year's budget, the administration indicated that it was developing a proposal to impose an excise tax on OCS oil and gas but provided no specifics. While this budget does not include a tax proposal, a number of fee changes have been proposed that will impact oil and gas companies. They include a user fee for processing oil and gas drilling permits and inspecting operations on federal lands and waters, fees for new nonproducing oil and gas leases (both onshore and offshore) to encourage more timely production, and adjustments to oil and gas royalty rates.

Taxpayer reporting and compliance provisions

This year's budget includes a number of information reporting and other provisions aimed at closing the “tax gap,” and improving taxpayer compliance and tax administration.

Worker classification – This year's budget includes a new proposal concerning worker classification. Whether a worker is classified as an employee or an independent contractor is an area of significant controversy between taxpayers and the IRS. The administration believes that workers, service recipients, and tax administrators would benefit from reducing uncertainty about worker classification, eliminating the potential competitive advantages and incentives to misclassify workers, and reducing opportunities for noncompliance by workers. Toward that end the administration proposes to:

- **Permit the IRS to issue worker classification guidance** – The Department of the Treasury and the IRS would be permitted to issue generally applicable guidance on the proper classification of workers under common law standards. They would, according to the administration, be directed interpret common law in a neutral manner recognizing that many workers are, in fact, not employees. Industry- or job-specific specific guidance would be also developed that includes safe harbors and/or rebuttable presumptions. Priority for the development of guidance would be given to industries and jobs in which application of the common law test has been particularly problematic, where there has been a history of worker misclassification, or where there have been failures to report compensation paid.
- **Require reclassification of misclassified workers** – Service recipients would be required to prospectively reclassify workers who are currently misclassified and whose reclassification has been prohibited under current law. Those service recipients who voluntarily reclassify their workers and file the required information returns with the IRS

before being contacted by the agency would be eligible for the current-law reduced penalty for misclassification. In addition, the reduced penalties may be waived for service recipients with only a small number of employees and a small number of misclassified workers.

- **Require service recipient notification to independent contractors** – Service recipients would be required to give notice to independent contractors, when they first begin performing services for the service recipient, that explains how they will be classified and the consequences thereof – for example, tax implications, workers' compensation implications, wage and hour implications.
- **Permit independent contractors to require withholding by service recipient** – Independent contractors receiving payments totaling \$600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold for federal tax purposes a flat rate percentage of their gross payments, with the flat rate percentage being selected by the contractor.
- **IRS notification to the Department of Labor** – The IRS would be permitted to disclose to the Department of Labor information about service recipients whose workers are reclassified.

The proposal would be effective on enactment, but prospective reclassification of those covered by the current special provision would not be effective until the first calendar year beginning at least one year after date of enactment. The transition period could be up to two years for independent contractors with existing written contracts establishing their status. The proposal is expected to raise \$7 billion over 10 years.

Information reporting – The budget includes proposals that address:

- **Information reporting on payments to corporations** – The proposal would modify existing rules regarding reporting of payments made to corporations. It would require a business to file a Form 1099 to report payments made to a corporation totaling \$600 or more in a calendar year. The provision would be effective for payments made after December 31, 2010, and would raise an estimated \$9 billion over 10 years.
- **Information reporting for rental property expenses** – Recipients of real estate rental income that make payments of \$600 or more to a service provider (such as a plumber or accountant) in the course of earning rental income would be required to send an information return (generally, Form 1099-MISC) to the IRS and to the service provider. Exceptions would be made for particularly burdensome situations, such as for taxpayers (including members of the military) who rent their principal residence on a temporary basis, or for those who receive only small amounts of rental income. The proposal would be effective for tax years beginning after December 31, 2010, and would raise about \$3 billion over 10 years.
- **Information reporting and withholding for contractors** – Contractors receiving \$600 or more from a business would be required to provide the business with a Form W-9 with a certified TIN. The business would be responsible for verifying the TIN information with the Internal Revenue Service, which would validate the TIN. Should the contractor fail to provide the appropriate information, the business would be directed to withhold a percentage of gross payments. The flat-rate withholding could be at a rate of 15, 20, 30, or 35 percent, to be selected by the contractor. The proposal would raise \$704 million over 10 years, effective for payments to contractors after December 31, 2010.
- **Information reporting on government contracts** – The Treasury and IRS would be directed to provide regulations requiring information reporting on nonwage payments made by federal, state, or local governments to purchase property or services. Certain types of payments could be excluded from this requirement, including payments of interest, payments for real property, payments to tax-exempt entities or foreign governments, intergovernmental payments, and payments under a classified or confidential contract. The proposal would raise \$388 million over 10 years, effective for payments made after December 31, 2010.
- **Information reporting for private separate accounts of life insurance companies** – The proposal would require life insurance companies to provide the TINs of the policyholder, the policy number, the amount of accumulated untaxed income, the account value, and the portion of the value that was invested in one or more private separate accounts. Information reporting would be required when the cash value of a contract is wholly or partially invested in a private separate account during the taxable year. The provision would be effective for taxable years beginning after December 31, 2010, and would raise \$58 million over 10 years.

Tax administration – Major proposals related to tax administration include:

- **E-filing by certain large organizations** – The administration proposes to require corporations and partnerships that file a Schedule M-3 to file returns electronically. For other large taxpayers that are not required to file a Schedule M-3 (such as exempt organizations), regulatory authority would be granted to allow the current threshold of filing 250 or more returns in a calendar year to be reduced. The e-filing requirement may also be waived if a taxpayer is unable to comply due to technological constraints or if compliance would financially burdensome. The proposal would be effective for tax years ending after December 31, 2010, and is estimated to have no revenue impact.
- **Liability for employee leasing companies** – The proposal would set standards for holding employee leasing companies jointly and severally liable with their clients for federal employment taxes. The proposal would raise \$71 million over 10 years, effective for wages paid after December 31, 2010.
- **Increased information return penalties** – Information return penalties for failure to disclose certain information to the IRS would be increased. The first-tier penalty would increase from a current-law \$15 to \$30 per return, and the maximum penalty for a calendar year would increase from \$75,000 to \$250,000. The second-tier penalty would increase from \$30 to \$60 per return, and the maximum would increase from \$150,000 to \$500,000. The third-tier penalty would increase from \$50 to \$100, while the maximum would increase from \$250,000 to \$1.5 million. Small filers would see an increase in the calendar-year maximum from \$25,000 to \$75,000 for first-tier, \$50,000 to \$200,000 for second-tier, and \$100,000 to \$500,000 for third-tier penalties. The penalty minimum for intentional disregard would increase from \$100 to \$250 for each failure. The penalties would be adjusted for inflation every five years. The proposal would raise \$376 million over 10 years, effective for information returns required to be filed after December 31, 2011.

Other tax administration provisions would:

- Expand the bad check penalty to cover all commercially acceptable payment instruments tendered to satisfy a tax liability, effective after December 31, 2010;
- Establish a penalty of \$25,000 for corporations (\$5,000 for tax-exempt organizations) for failure to comply with electronic return requirements, effective for returns filed after December 31, 2011;
- Allow the IRS to issue levies prior to a collection due process hearing for federal contractors with delinquent tax debt, effective for levies issued after December 31, 2010;
- Clarify that the IRS can levy 100 percent of any payment due to a federal vendor with unpaid tax liabilities, effective for payments made after the date of enactment;
- Allow the IRS and Treasury to assess court-ordered restitution as tax, effective after December 31, 2010;
- Eliminate requirements that an initial offer-in-compromise include a nonrefundable payment of any portion of the taxpayer's offer, effective for offers submitted after the date of enactment;
- Expand IRS access to information in the National Directory of New Hires for tax administrative purposes, effective on the date of enactment;
- Make repeated willful failure to file a tax return a felony, effective for returns required to be filed after December 31, 2010;
- Treat Indian tribal governments that impose alcohol, tobacco, fuel excise, income, or wage taxes as states for information-sharing purposes, and require Indian tribal governments that receive federal tax return information to safeguard it according to prescribed protocols, effective for disclosures made after enactment;
- Extend the statute of limitations where state adjustment affects federal tax liability, effective for returns required to be filed after December 31, 2010; and
- Clarify taxpayer privacy law by stating that it does not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and the subject of an investigation when contacting third parties in connection with a civil or criminal tax investigation, effective for disclosures made after the date of enactment.

Dividends received in reorganization exchanges

Under section 356(a)(1), if as part of a reorganization transaction an exchanging shareholder receives in exchange for its stock of the target corporation both stock and property (boot) that cannot be received without the recognition of gain, the exchanging shareholder is required to recognize gain equal to the lesser of the gain realized in the exchange or the amount of boot received (the "boot within gain" limitation). Further, under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to

the extent of the shareholder's ratable share of the corporation's earnings and profits. The remainder of the gain (if any) is treated as gain from the exchange of property.

The administration believes that there is no significant policy reason to vary the treatment of a distribution that otherwise qualifies as a dividend by reference to whether it is received in the normal course of a corporation's operations or as part of a reorganization exchange. The administration further believes that in cross-border reorganizations, the boot-within-gain limitation permits U.S. shareholders to repatriate previously untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences.

The proposal would repeal the limitation in the case of any reorganization transaction if the exchange has the effect of the distribution of a dividend under section 356(a)(2), effective for taxable years beginning after 2010. This proposal is estimated to raise \$788 million over 10 years.

Unemployment insurance surtax

The Federal Unemployment Tax Act currently imposes a payroll tax on employers of 6.2 percent of the first \$7,000 paid annually to each employee. This 6.2 percent rate includes a temporary surtax of 0.2 percent. States also impose an unemployment tax on employers. Employers in states that meet certain federal requirements are allowed a credit for state unemployment taxes of up to 5.4 percent, making the minimum net federal tax rate 0.8 percent, of which 0.2 percent is the temporary surtax that was most recently extended through June 30, 2011. To maintain the continued solvency of the federal unemployment trust funds, the proposal would make the 0.2 percent surtax permanent at a cost of almost \$14.2 billion over 10 years.

Bonus depreciation and other business tax relief

To encourage new investment and promote economic recovery, the proposal would extend through 2010 the first-year bonus depreciation deduction equal to 50 percent of the cost of qualified property and provide for an election to claim research or alternative minimum tax (AMT) tax credits in lieu of the additional first-year depreciation. The proposal would apply to qualifying property placed in service in calendar year 2010 (2011 for certain long-lived property, transportation property, and aircraft) and would cost \$20.1 billion over 10 years.

Remove cell phones from "listed property" – Under current law, cell phones are "listed property" for which business deductions are limited or disallowed unless the taxpayer substantiates the expense and business use and purpose. If the listed property is not used predominantly for business purposes (or if not properly substantiated), annual depreciation deductions (and any small business expensing deduction) are limited. Further, the fair market value of any personal usage by an employee is includable as a fringe benefit in the employee's gross income. To relieve the substantiation burden on employers, employees, and the IRS, the proposal would de-list cell phones (or other similar telecommunications equipment), effectively removing the requirement of strict substantiation of use and the limitation on depreciation deductions. In addition, the fair market value of personal use of a device provided primarily for business purposes would be excluded from gross income. The proposal would cost about \$2.8 billion over 10 years.

Small-business capital gains – To further "encourage and reward new investment in qualified small business stock," the proposal would permit taxpayers other than corporations to exclude 100 percent of the gain from the sale of certain small business stock acquired at original issue and eliminate the AMT preference item for gain excluded under this provision. A five-year holding period and other provisions applying to the section 1202 exclusion would also apply, and the proposal would impose additional documentation requirements to assure compliance. The exclusion was increased to 75 percent for stock acquired after February 17, 2009, and in 2010 as part of the ARRA.

The proposal would be effective for qualified small business stock issued after February 17, 2009. It is estimated to cost almost \$8.1 billion over the 2011-2020 budget window.

Small business expensing – The proposal would extend the \$250,000 expensing and \$800,000 annual investment limits for one year, through taxable years beginning in 2010, at a cost of \$753 million over 10 years for annual investment expenditures for qualifying property.

Extension of expiring provisions

Permanent research credit – The budget proposal would permanently extend the research and experimentation credit, at a cost of about \$82.6 billion over 10 years.

Extend and increase New Markets Tax Credit – The proposal would extend the New Markets Tax Credit for two years (2010 and 2011), increase the allocation amount to \$5 billion each year, and would make other, unspecified improvements to the credit. The proposal would cost \$3.4 billion over 10 years.

Other extenders – The administration also proposes to extend certain expired or expiring business tax provisions through 2011, but, as was the case with last year's budget, it does not provide details on most provisions. Those provisions identified include the:

- State and local sales tax deduction;
- Subpart F active financing and lookthrough exceptions;
- Modified recovery period for leasehold improvements and qualified restaurant property;
- Exclusion from unrelated business income of certain payments to controlling exempt organizations; and
- Incentives for empowerment and community renewal zones.

The administration did not include a full list of expiring provisions, and it is unclear whether a more comprehensive list will be revealed in the coming months. Temporary incentives provided for the production of fossil fuels would be allowed to expire as scheduled under current law. (See related discussion in the Energy section of this report for details.) The administration estimates the extenders package will cost \$46.7 billion over 10 years.

Provisions affecting high-income individuals

President Obama's budget continues to call for shifting the tax burden more towards high-income individuals – those defined as earning annual income over \$250,000 for couples and \$200,000 for singles. Following this mandate, the budget recommends nearly \$1 trillion dollars in revenue raisers affecting that taxpayer group. If all these proposals were enacted, high-income taxpayers could see substantial increases in their effective tax rates starting in 2011.

Tax increases, deduction limitations for high-income earners – The core set of budget proposals to increase income taxes on higher-income individuals, most of which Obama has recommended since his campaign, include:

- Reinstating the top two individual income tax rates, currently 33 and 35 percent, at their pre-2001 levels – 36 and 39.6 percent – beginning in 2011. Using 2010 standard deductions and personal exemptions to illustrate, the 36 percent bracket would begin at taxable income of \$190,650 for singles and \$231,300 for married couples, while the 39.6 bracket would begin at \$373,650. The taxable income level at which the 36 and 39.6 percent rates would apply would be indexed for inflation for 2011 and each year thereafter. The 28 percent tax rate bracket would be expanded to reflect modifications to the upper limit of that bracket (where the 36 percent bracket would begin).
- Increasing the capital gains and dividends rate to 20 percent for taxpayers falling into the 36 and 39.6 percent tax brackets. The reduced rates on gains on assets held over five years would be repealed. In both cases, the increased rates would apply beginning in 2011. All other individual taxpayers would continue to be taxed at the zero and 15 percent tax rates for long-term capital gains and qualified dividend incomes.
- Reinstating in 2011 the personal exemption phase-out and itemized deduction limitation. Both are fully phased out in 2010 as provided under current law. Phase-out thresholds would be indexed for 2011 starting from \$200,000 of adjusted gross income for singles and \$250,000 for joint filers, and then indexed annually for inflation.

The Treasury Department estimates these proposed tax increases would raise nearly \$678.3 billion over 10 years, up from \$615 billion in the FY2010 budget.

Limit tax rate at which itemized deductions can reduce tax liability – The administration again proposes to limit the tax rate at which itemized deductions reduce tax liability for high-income taxpayers. Under this proposal, taxpayers in the highest two brackets (36 and 39.6 percent) would deduct itemized expenses at the 28 percent rate. For example, looking at next year and assuming the top two brackets increase, a taxpayer in the 39.6 percent bracket could receive a benefit of \$396 for a \$1,000 charitable contribution. If the administration's curb on the savings provided by itemized deductions were

enacted, the benefit for the same contribution would be limited to \$280. A similar limitation would apply under the AMT. Opponents of the proposal argue that it could result in lower aggregate charitable contributions and raise the after-tax cost of financing and maintaining a residence.

Despite the opposition to this proposal in 2009, certain Democratic senators including taxwriter Jay Rockefeller, D-W.Va., proposed a slightly modified version during Senate Finance Committee deliberations on health care reform legislation. Rockefeller, along with Sens. Tom Carper, D-Del., John Kerry, D-Mass., Robert Menendez, D-N.J., and Charles Schumer, D-N.Y., proposed limiting to 35 percent the rate at which high-income taxpayers could deduct itemized expenses. While the efforts ultimately failed, such a proposal could arise again this Congress.

The Treasury Department estimates that the proposal would raise \$291 billion over 10 years, an increase of almost \$25 billion from the provision in last year's budget. It would be effective for taxable years beginning after December 31, 2010.

A Deloitte Tax LLP analysis illustrates the effect of the tax proposals targeting high-income individuals. A married couple with \$150,000 of household income could expect to save about \$3,400. The savings is attributable to extending the AMT patch and the related reduction of the couple's AMT liability.

In contrast, a married couple with \$5 million of household income could expect an increase of about \$237,000 as a result of the rate increases. This does not include the possible effect of limiting the benefit of itemized deductions to a rate of 28 percent. That change could boost the couple's taxes even more.

Planning ahead – Although prospects for the proposal to cap the benefit of itemized deductions at 28 percent remain uncertain, the other increases seem virtually certain to take place. In anticipation of higher rates, many taxpayers will want to consider accelerating income, such as deferred compensation or capital gains transactions.

For taxpayers who consistently owe AMT from year to year, the proposed tax rate increases and deduction limitations may not pose as significant a threat. In some cases, these proposed changes may merely reduce the amount of AMT owed without increasing the overall tax burden. However, individuals who primarily owe tax on investment income that is taxed at the lower, more beneficial rates for both regular and AMT purposes may find that the proposed rate changes increase their effective tax rate by about 5 percentage points – increasing their total tax burden by a third.

Budget assumptions – Similar to its FY2010 budget, the White House has built several significant assumptions related to individual tax rates into its budget baseline. Specifically, the budget assumes that:

- The 2001 and 2003 Bush tax cuts will be extended for lower- and middle-income taxpayers;
- The estate tax will be frozen at 2009 levels – that is, an exemption of \$3.5 million (\$7 million for married couples) and a top rate of up to 45 percent; and
- The increased individual AMT exemption amounts for 2009 that were enacted in the ARRA – \$46,700 (for individuals) and \$70,950 (married filing jointly) – will be indexed for inflation going forward, and the ability to use nonrefundable personal credits against the AMT will be extended.

Congress will likely be on board with the administration's proposals for making permanent the low- and middle-income tax cuts, and the indexing of the AMT exemption. However, the direction that lawmakers take with the estate tax is less clear. For 2010, the estate tax has been repealed. Without further congressional action, it is scheduled to reappear beginning in 2011 with a top rate of 55 percent and an exemption of \$1 million (the top rate and exemption amount in effect under pre-2001 law).

In the past, the House has approved legislation that would have made permanent the 2009 estate tax structure, but the Senate failed to act on the proposal. A coalition of Democratic and Republican senators may push for more estate tax relief than that provided by the 2009 regime. The Senate and House may not easily reach an agreement in this area. When Congress addresses the estate tax, it's possible that the budget proposals recommended by the administration could be brought into those discussions. With the exception of limitations on valuation discounts, Congress has not yet seriously considered the other estate tax loophole closers espoused by the administration.

Jobs and savings incentives

Two new proposals address supporting the goals job growth and savings. The budget proposes to eliminate barriers to working or pursuing further schooling by expanding the child and dependent care tax credit and to promote retirement savings by requiring employers to provide automatic enrollment in IRAs.

Child and Dependent Care Tax Credit – The budget proposes to expand the child and dependent care credit currently available for persons who are working or looking for work, and who incur childcare expenses. Current law provides up to 35 percent of \$3,000 in eligible care expenses for one child (\$6,000 for two more children). The credit is phased down for income above \$15,000 until the allowable percentage reaches 20 at \$43,000 of income and above. No further limits exist. The proposal would permanently increase the phase-down threshold to between \$85,000 and \$113,000, but otherwise leave the applicable percentages unchanged. The proposal would cost \$12.6 billion over 10 years and would be effective for tax years beginning after December 31, 2010.

Automatic enrollment in workplace pension plans – The budget also provides for a system of automatic workplace pensions to operate alongside Social Security. Under this proposal, employers in operation for at least two years that have 10 or more employees would be required to offer an automatic IRA option to employees on a payroll-deduction basis if the employer did not already provide a qualified retirement plan or SIMPLE plan. Employees could opt out if they choose. Employers would also claim a temporary tax credit of up to \$250 for each employee for a two-year period for making automatic payroll deposit IRAs available. The credit would also be available to employers not required to offer automatic IRAs. The proposal would cost \$10.4 billion over 10 years and would be effective after 2011.

Extension of stimulus tax credits

The budget also would make permanent or expand several of the middle-class tax cut initiatives in the ARRA.

Making Work Pay Credit – President Obama’s budget would extend for 2011 the Making Work Pay Credit (essentially a refund of a portion of payroll taxes) as enacted for 2009 and 2010 under ARRA. The credit provides up to \$400 for individuals and \$800 for couples, and begins to phase out when modified adjusted gross income exceeds \$75,000 for singles and \$150,000 for married couples. Notably, the FY 2010 budget had proposed to make the credit permanent, index the phase-out range for inflation, and increase the threshold, but the cost was prohibitive. The one-year extension is estimated to cost \$61.2 billion over 10 years.

American Opportunity Tax Credit – The budget would make permanent the American Opportunity Tax Credit – which currently applies only for 2009 and 2010 – and index the expense amounts and phase-out limits for inflation beginning after December 31, 2010. The provision would cost \$75.5 billion over 10 years.

Extend COBRA health insurance premium assistance – The budget proposes to extend COBRA premium assistance, scheduled to expire February 28, 2010, through December 31, 2010. The duration of the COBRA premium assistance that results from an involuntary termination of employment after February 28, 2010 would be 12 months. The provision is estimated to cost \$5.5 billion over 10 years. Transition relief would be provided if the extension is not enacted before the current expiration date.

\$250 Economic Recovery Payments – The budget proposes to provide a \$250 Economic Recovery Payment in 2010 to each adult eligible (\$500 to a married couple where both spouses are eligible) for Social Security, railroad retirement, veteran’s compensation or pension, or Supplemental Security Income (SSI) benefits (excluding individuals who receive SSI while in a Medicaid institution). The budget also proposes to provide a \$250 refundable tax credit to federal, state, and local government retirees who are not eligible for Social Security benefits. Retirees who are employed and eligible for the Making Work Pay Tax Credit will have their Making Work Pay Tax Credit reduced (but not below zero) by the amount of the recovery payment and refundable tax credit. The proposal would cost \$212 million.

Saver’s Credit – The budget would modify the existing Saver’s Credit to provide a 50 percent match on the first \$500 of retirement savings for qualifying individuals (\$1,000 for married couples). The eligibility income threshold would be increased to \$65,000 for couples (\$48,750 for heads of households, and \$32,500 for singles and married filing separately). The credit would phase out at a 5 percent rate when adjusted gross income exceeds those thresholds. The thresholds would be indexed for inflation beginning in taxable year 2012. The credit could be deposited automatically into a qualified

retirement plan account or IRA and would be fully refundable. The provision would cost \$29.8 billion over 10 years and would be effective after 2010.

Child Tax Credit – The ARRA increased the eligibility for the refundable child tax credit by modifying the earned income formula. The president’s FY 2011 budget incorporates a continuation of the ARRA policy into the baseline projection.

Earned Income Tax Credit – The ARRA also temporarily increased the Earned Income Tax Credit (EITC) from 40 to 45 percent for 2009 and 2010 for families with three or more qualifying children and increased the income thresholds for the phase-out for married couples filing a joint return. The budget would make the expansion for families with three or more children permanent after December 31, 2010 at a cost of \$15.2 billion.

The budget assumes in its baseline the permanent extension of the increased threshold (\$5,000 above the threshold for single filers) for married couples filing a joint return. Additionally, the budget proposes eliminating the Advanced Earned Income Tax Credit, which allows taxpayers who expect to qualify for the EITC and have at least one qualifying child to receive part of the credit in each paycheck during the year the taxpayer qualifies for the credit. This proposal would save \$760 million over 10 years.

Estate and gift tax changes

The White House continues to push for the closing of perceived loopholes in the area of estate and gift taxation. These proposals would require consistent treatment of asset basis for transfer and income tax purposes, place limits on valuation discounts, and require a minimum term for grantor retained annuity trusts (GRATs).

Consistency in value – The Obama budget would codify the legal doctrine of “duty of consistency,” requiring consistent treatment of asset basis for both income and transfer tax purposes. The basis of property acquired from a decedent under section 1014 would have to equal the value of the property for estate tax purposes. The basis of property received by gift during the life of the donor would have to equal the donor’s basis determined under section 1015. In other words, the basis of the property in the hands of the recipient would be no greater than the value of that property as determined for estate and gift tax purposes. A reporting requirement would also be imposed in which necessary information would be provided to the IRS. A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements. The proposal would be effective as of the date of enactment.

Valuation discounts for property transfers – Recognizing that an array of judicial decisions and new state statutes have weakened restrictions for valuing transferred interests under section 2704(b), the administration has proposed disregarding certain temporary limits that are placed on transfers related to interests in family-controlled entities. The “disregarded restrictions” would include: (1) limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard identified in regulations; and (2) any limitation on a transferee’s ability to be admitted as a full partner or holder of an equity interest in the entity. Instead, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions specified in regulations. The regs would also identify safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. The proposal would make conforming clarifications with respect to the interaction of this proposal with the transfer tax marital and charitable deductions.

The changes would be significantly narrower than a proposal sponsored by House Ways and Means Committee member Earl Pomeroy, D-N.D., who has in the past proposed limiting the use of minority discounts for transfers of family limited partnership interests. Congress could rely more heavily on the Pomeroy proposal for reforming estate taxes as the budget process moves forward.

The Obama budget proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

Minimum term for GRATs – Targeting a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, the proposal requires that a GRAT have a minimum term of ten years, instead of a more typical term of two years. The longer life would increase the chance that the grantor’s death occurs during the annuity period, resulting in the GRAT assets being included in the grantor’s estate versus being transferred to the beneficiaries of the GRAT if the

grantor dies after the term. The change would make a significant impact on the ability to use GRATs for generation-skipping transfer tax planning. The proposal would apply to trusts created after the date of enactment.

The estate and gift tax changes would raise an estimated \$23.7 billion over 10 years, beginning in 2010.

Provisions affecting state and local governments

The budget package includes proposals to:

- **Allow offset of federal income tax refunds to collect delinquent state income taxes for out-of-state residents** – Current law permits federal tax refunds to be offset to collect delinquent state income tax obligations but only if the delinquent taxpayer resides in the state collecting the tax. This provision would allow federal tax refunds to be offset to collect delinquent state tax obligations regardless of where the debtor resides.
- **Implement unemployment insurance integrity legislation** – This provision would boost the ability of states to recover overpayments of unemployment insurance benefits and to use a portion of the recovered benefits to fund enforcement programs in this area, including identification of misclassified employees. It also would require states to impose a monetary penalty on unemployment insurance benefit frauds, require states to charge employers found to be at fault when their actions lead to overpayments, expand collection of delinquent unemployment insurance overpayments and employer taxes through garnishment of federal tax refunds, and improve the accuracy of hiring data in the National Directory of New Hires.
- **Extend option for cash assistance to states in lieu of housing tax credits** – Under this provision, states would be allowed to elect cash assistance in lieu of low-income housing tax credits for 2010 to finance certain low-income residential rental properties.
- **Reform and extend Build America Bonds** – This provision would make the Build America Bond program permanent and expand it to include additional uses for which state and local governments may use tax-exempt bonds under existing law.
- **Restructure New York City Liberty Zone provisions** – The administration proposes restructuring assistance to New York for rebuilding areas affected by the September 11 terrorist attacks. The proposal would provide tax credits of \$200 million annually from 2011 to 2020 to New York State and New York City for construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. The credits could be used to offset any payments made by the state or the city under any provision of the Internal Revenue Code, including tax withholding. The proposal would be effective on January 1, 2011, and would cost \$2 billion through 2020.

Outlook

As he did last year, the president has fashioned a budget that allows Congress to avoid taking immediate action on the largest and more controversial proposed business and industry tax hikes. He continues to call for business tax increases that would primarily be effective in 2011. For its part, Congress may be less enthusiastic about voting to raise taxes before the November election and choose to kick difficult tax increase decisions down the road and into next year. Moreover, emerging pay-as-you-go budget rules will likely allow lawmakers to address “must do” priorities such as extending the Bush tax cuts for the middle class, extending the AMT patch, and retroactively reinstating the estate tax at its 2009 levels without the need to find offsetting revenue.

If Congress turns to additional tax cuts such as added alternative energy credits or the extension of expiring provisions, however, then some of the president’s more controversial proposed increases – such as bank fees, international tax reforms, repeal of oil, gas, and coal tax incentives, carried interest, and inventory method changes – could receive favorable consideration. Taxpayers must remain diligent and plan appropriately or risk being uninformed and unprepared for the sudden emergence of adverse changes.

In the near term, Congress will want to move quickly on a jobs bill and an extension of COBRA benefits. This legislation is unlikely to be a viable forum for tax increases. At some point, lawmakers will renew efforts to move health care reform legislation – something that will require tax increases if Congress wants to provide coverage to uninsured individuals.

The major work of the year will be a bill to prevent middle class rate increases from occurring in 2011. Congress will want to finish work on this legislation in time for the month-long August recess. This is the bill where we will likely also see Congress take up and address the expiration of the estate tax, and provide for the extension of expiring provisions.

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