TECHNICAL EXPLANATION OF THE TAX PROVISIONS IN SENATE AMENDMENT 4594 TO H.R. 5297, THE "SMALL BUSINESS JOBS ACT OF 2010," SCHEDULED FOR CONSIDERATION BY THE SENATE ON SEPTEMBER 16, 2010

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the tax provisions contained in Senate Amendment 4594 to H.R. 5297, the "Small Business Jobs Act of 2010," scheduled for consideration by the Senate on September 16, 2010. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Tax Provisions in Senate Amendment 4594 to H.R. 5297, the "Small Business Jobs Act of 2010," Scheduled for Consideration by the Senate on September 16, 2010,* (JCX-47-10), September 16, 2010. This document can also be found on our website at www.jct.gov.

I. SMALL BUSINESS RELIEF

A. Providing Access to Capital

1. Temporary exclusion of 100 percent of gain on certain small business stock (sec. 2011 of the bill and sec. 1202 of the Code)

Present Law

In general

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.[2] The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[3] A percentage of the excluded gain is an alternative minimum tax preference;[4] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Gain from the sale of qualified small business stock generally is taxed at effective rates of 14 percent under the regular tax[5] and (i) 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (ii) 19.88 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.[6]

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[2] Sec. 1202.

[3] Sec. 1(h).

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

[5] The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

[6] The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

Temporary increase in exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and before January 1, 2011, is increased to 75 percent. As a result of the increased exclusion, gain from the sale of this qualified small business stock held at least five years is taxed at effective rates of seven percent under the regular tax[7] and 12.88 percent under the alternative minimum tax.[8]

Explanation of Provision

Under the provision, the percentage exclusion for qualified small business stock acquired during 2010 is increased to 100 percent and the minimum tax preference does not apply. Thus, no regular tax or alternative minimum tax is imposed on the sale of this stock held at least five years.

Effective Date

The provision is effective for stock issued after the date of enactment and before January 1, 2011.

2. Five-year carryback of general business credit of eligible small business (sec. 2012 of the bill and sec. 39 of the Code)

Present Law

The general business credit generally may not exceed the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax or 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000.[9] General business credits in excess of this limitation may be carried back one year and forward up to 20 years.[10]

Explanation of Provision

The provision extends the carryback period for eligible small business credits from one to five years. Under the provision, eligible small business credits are defined as the sum of the general business credits determined for the taxable year with respect to an eligible small business. An eligible small business is, with respect to any taxable year, a corporation, the stock of which is not publicly traded, or a partnership which meets the gross receipts test of section

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

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

[9] Sec. 38(c). The general business credit is the sum of the credits allowed under sec. 38(b).

[10] Sec. 39.

448(c), substituting $50 million for $5 million each place it appears.[11] In the case of a sole proprietorship, the gross receipts test is applied as if it were a corporation. Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current year business credits.

Effective Date

The provision is effective for credits determined in the taxpayer's first taxable year beginning after December 31, 2009.

3. General business credit of eligible small business not subject to alternative minimum tax (sec. 2013 of the bill and sec. 38 of the Code)

Present Law

For any taxable year, the general business credit, which is the sum of the various business credits, generally may not exceed the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax or 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000. Any general business credit in excess of this limitation may be carried back one year and forward up to 20 years. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. However, in applying the tax liability limitation to certain specified credits that are part of the general business credit, the tentative minimum tax is treated as being zero.[12] Thus, the specified credits may offset both regular and alternative minimum tax liability.

Description of Proposal

The provision provides that the tentative minimum tax is treated as being zero for eligible small business credits. Thus, an eligible small business credit may offset both regular and alternative minimum tax liability. Under the provision, eligible small business credits are defined as the sum of the general business credits determined for the taxable year with respect to an eligible small business. An eligible small business is, with respect to any taxable year, a corporation, the stock of which is not publicly traded, or a partnership, which meets the gross receipts test of section 448(c), substituting $50 million for $5 million each place it appears.[13] In the case of a sole proprietorship, the gross receipts test is applied as if it were a corporation.

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[11] For example, a calendar year corporation meets the $50 million gross receipts test for the 2010 taxable year, if as of January 1, 2010, its average annual gross receipts for the 3-taxable-year period ending December 31, 2009, does not exceed $50 million. The aggregation and special rules under sections 448(c)(2) and (3) apply in applying the test.

[12] See section 38(c)(4)(B) for a list of the specified credits.

[13] For example, a calendar year corporation meets the $50 million gross receipts test for the 2010 taxable year, if as of January 1, 2010, if its average annual gross receipts for the 3-taxable-year period ending December 31, 2009, does not exceed $50 million. The aggregation and special rules under sections 448(c)(2) and (3) apply for purposes of the test.

Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current year business credits.

Effective Date

The proposal is effective for credits determined in a taxpayer's first taxable year beginning after December 31, 2009.

4. Temporary reduction in recognition period for S corporation built-in gains tax (sec. 2014 of the bill and sec. 1374 of the Code)

Present Law

A "small business corporation" (as defined in section 1361(b)) may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass though to its shareholders. Each shareholder takes into account separately its share of these items on its individual income tax return.[14]

A corporate level tax, at the highest marginal rate applicable to corporations (currently 35 percent) is imposed on an S corporation's gain that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, i.e., the 10-year period beginning with the first day of the first taxable year for which the S election is in effect.[15] For any taxable year beginning in 2009 and 2010, no tax is imposed on an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.[16] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, for taxable years beginning in 2009 and 2010, no tax is imposed under section 1374 after the seventh taxable year the S corporation election is in effect.

The built-in gains tax also applies to gains with respect to net recognized built-in gain attributable to property received by an S corporation from a C corporation in a carryover basis transaction.[17] In the case of built-in gain attributable to an asset received by an S corporation from a C corporation in a carryover basis transaction, the recognition period rules are applied by

[14] Sec. 1366.

[15] Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation.

[16] Sec. 1374(d)(7)(B).

[17] Sec. 1374(d)(8). With respect to such assets, the recognition period runs from the day on which such assets were acquired (in lieu of the beginning of the first taxable year for which the corporation was an S corporation). Sec. 1374(d)(8)(B).

substituting the date such asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.[18]

Gains recognized in the recognition period are not built-in gains to the extent they are shown to have arisen while the S election was in effect or are offset by recognized built-in losses. The amount of the built-in gains tax is treated as a loss taken into account by the shareholders in computing their individual income tax.[19]

Explanation of Provision

For taxable years beginning in 2011, the provision provides that for purposes of computing the built-in gains tax, the "recognition period" is the five-year period[20] beginning with the first day of the first taxable year for which the corporation was an S corporation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

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[18] Shareholders continue to take into account all items of gain and loss under section 1366.

[19] Sec. 1366(f)(2).

[20] The 5-year period refers to 5 calendar years from the first day of the first taxable year for which the corporation was an S corporation.

B. Encouraging Investment

1. Increase and expand expensing of certain depreciable business assets (sec. 2021 of the bill and sec. 179 of the Code)

Present Law

A taxpayer that satisfies limitations on annual investment may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[21] For taxable years beginning in 2010, the maximum amount that a taxpayer may expense is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000.[22] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property.

For taxable years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[23]

Explanation of Provision

The provision increases the maximum amount a taxpayer may expense under section 179 to $500,000 and increases the phase-out threshold amount to $2 million for taxable years

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

[22] The temporary $250,000 and $800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, and extended for taxable years beginning in 2010 by the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147.

[23] Sec. 179(c)(1).

beginning in 2010 and 2011. Thus, the provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2009 and before 2012, is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2 million.

The provision also temporarily expands the definition of property qualifying for section 179 to include certain real property—specifically, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.[24] The maximum amount with respect to real property that may be expensed under the proposal is $250,000.[25] In addition, section 179 deductions attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible section 179 property includes qualified real property. Thus under the provision, if a taxpayer's section 179 deduction for 2010 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2011 in the manner under present law. Any such amounts that are not used in 2011, plus any 2011 disallowed section 179 deductions attributable to qualified real property, are treated as property placed in service in 2011 for purposes of computing depreciation. The carryover amount from 2010 is considered placed in service on the first day of the 2011 taxable year.[26]

The provision also permits a taxpayer to elect to exclude real property from the definition of section 179 property.

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[24] For purposes of the provision, qualified leasehold improvement property has the meaning given such term under section 168(e)(6), qualified restaurant property has the meaning given such term under section 168(e)(7) (and includes a building described in section 168(e)(7)(A)(i) that is placed in service after December 31, 2009 and before January 1, 2012), and qualified retail improvement property has the meaning given such term under section 168(e)(8) (without regard to section 168(e)(8)(E)).

[25] For example, assume that during 2010, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $350,000. Assuming the company has no other asset purchases during 2010, and is not subject to the taxable income limitation, the maximum section 179 deduction the company can claim for 2010 is $350,000 ($100,000 with respect to the equipment and $250,000 with respect to the qualifying leasehold improvements).

[26] For example, assume that during 2010, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $200,000. Assume the company has no other asset purchases during 2010, and has a taxable income limitation of $150,000. The maximum section 179 deduction the company can claim for 2010 is $150,000, which is allocated pro rata between the properties, such that the carryover to 2011 is allocated $100,000 to the qualified leasehold improvements and $50,000 to the equipment.

Assume further that in 2011, the company had no asset purchases and had taxable income of $-0-. The $100,000 carryover from 2010 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2011 taxable year. The $50,000 carryover allocated to equipment is carried over to 2012 under section 179(b)(3)(B).

Effective Date

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

2. Extend the additional first-year depreciation allowance (sec. 2022 of the bill and sec. 168(k) of the Code)

Present Law

In general

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008 and 2009 (2009 and 2010 for certain longer-lived and transportation property).[27] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2009, a taxpayer purchased new depreciable property and places it in service.[28] The property's cost is $1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is $500. The remaining $500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or $100, is also allowed as a depreciation deduction in 2009. The total depreciation deduction with respect to the property for 2009 is $600. The remaining $400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[29] Second, the

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[27] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

[28] Assume that the cost of the property is not eligible for expensing under section 179.

[29] The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is

original use[30] of the property must commence with the taxpayer after December 31, 2007.[31] Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2010. An extension of the placed in service date of one year (i.e., to January 1, 2011) is provided for certain property with a recovery period of ten years or longer and certain transportation property.[32] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after December 31, 2007, and before January 1, 2010, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2010.[33] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2010. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred

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also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

[30] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

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

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

[32] Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding $1 million.

[33] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

before January 1, 2010 ("progress expenditures") is eligible for the additional first-year depreciation.[34]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The $8,000 increase is not indexed for inflation.

Explanation of Provision

The provision extends the additional first-year depreciation deduction for one year to apply to qualified property acquired and placed in service during 2010 (or placed in service during 2011 for certain long-lived property and transportation property).

Effective Date

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

[34] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

3. Disregard bonus depreciation in computing percentage completion (sec. 2023 of the bill and new sec. 460(c)(6) of the Code)

Present Law

Percentage-of-completion method

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[35] Under such method, the percentage completion is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs. Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities. The allocation of the costs to a contract is made in accordance with regulations.[36]

Additional first-year depreciation deduction ("bonus depreciation")

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under MACRS. Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (tangible property other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.[37] In general, the recovery periods for real property are 39 years for non-residential real property and 27.5 years for residential rental property. The depreciation method for real property is the straight-line method.

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008 and 2009 (2009 and 2010 for certain longer-lived and transportation property),[38] and for property placed in service in 2010 (2011 for certain longer-lived and transportation property) under section 2022 of the bill. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. The

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[35] Sec. 460(a).

[36] Treas. Reg. sec. 1.460-5.

[37] For certain property, including tangible property used predominantly outside of the United States, tax-exempt use property, tax-exempt bond-financed property, and certain other property, the MACRS "alternative depreciation system" of section 168(g) applies, generally increasing recovery periods and requiring straight-line depreciation.

[38] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[39] Second, the original use[40] of the property must commence with the taxpayer after December 31, 2007.[41] Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2011. An extension of the placed in service date of one year (i.e., to January 1, 2012) is provided for certain property with a recovery period of ten years or longer, and certain transportation property.[42] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after December 31, 2008, and before January 1, 2011, but only if no binding written contract for the acquisition is in effect before January 1, 2010, or (2) pursuant to a binding written contract which was entered into after

[39] The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

[40] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

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

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

[42] Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding $1 million.

December 31, 2008, and before January 1, 2011.[43] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2008, and before January 1, 2010. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2011 ("progress expenditures") is eligible for the additional first-year depreciation.[44]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. In addition, the limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The $8,000 increase is not indexed for inflation.

Explanation of Provision

The provision provides that solely for purposes of determining the percentage of completion under section 460(b)(1)(A), the cost of qualified property is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted.[45] Qualified property is property otherwise eligible for bonus depreciation that has a MACRS recovery period of 7 years or less and that is placed in service after December 31, 2009, and before January 1, 2011 (January 1, 2012, in the case of property described in section 168(k)(2)(B)[46]).

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[43] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

[44] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

[45] For example, assume a calendar year taxpayer is required to use the percentage-of-completion method to account for a long-term contract during 2010. Assume further that during 2010 the taxpayer purchases and places into service equipment with a cost basis of $500,000 and MACRS recovery period of 5-years. The taxpayer uses the equipment exclusively in performing its obligation under the contract. In computing the percentage of completion under section 460(b)(1)(A), the depreciation on the equipment (assuming a half-year convention) taken into account as a cost allocated to the contract for 2010 is $100,000 [$500,000/5*200%*.5]. The amount of the depreciation deduction that may be claimed by the taxpayer in 2010 with respect to the equipment is $300,000 [($500,000*50%) + (($500,000-(500,000*50%))/5*200%*.5)].

[46] Sec. 168(k)(2)(B) generally applies to property having longer production periods.

Effective Date

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

C. Promoting Entrepreneurship

1. Increase amount allowed as deduction for start-up expenditures (sec. 2031 of the bill and sec. 195 of the Code)

Present Law

Start-up expenditures

A taxpayer can elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins.[47] However, the $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds $50,000.[48] Start-up expenditures that are not deductible in the year in which the active trade or business begins are, at the taxpayer's election, amortized over a 15-year period beginning with the month the active trade or business begins.[49] Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began, including amounts paid or incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.[50]

Treasury regulations[51] provide that a taxpayer is deemed to have made an election under section 195(b) to amortize its start-up expenditures for the taxable year in which the active trade or business to which the expenditures relate begins. A taxpayer that chooses to forgo the deemed election must clearly elect to capitalize its start-up expenditures on its timely filed Federal income tax return for the taxable year the active trade or business commences. The election either to amortize or capitalize start-up expenditures is irrevocable and applies to all start-up expenditures related to the active trade or business.

Explanation of Provision

For taxable years beginning in 2010, the provision increases the amount of start-up expenditures a taxpayer can elect to deduct from $5,000 to $10,000 and increases the deduction phase-out threshold such that the $10,000 is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds $60,000.

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[47] Sec. 195(b)(1)(A).

[48] *Ibid*.

[49] Sec. 195(b)(1)(B).

[50] Sec. 195(c).

[51] Temp. Treas. Reg. sec. 1.195-1T(b).

Effective Date

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

2. Provision providing authorization of appropriations to the Office of the United States Trade Representative[52] (sec. 2032 of the bill)

Present Law

Current law authorizes funding for the Office of the United States Trade Representative ("USTR") to carry out the agency's functions; however, that authorization expired in 2004. The authorization currently exists through appropriations. USTR was appropriated $47,826,000 for fiscal year 2010.

Explanation of Provision

The provision authorizes additional appropriations in the amount of $5,230,000 for USTR to (1) analyze and develop opportunities for U.S. businesses to access foreign markets; and (2) enforce trade agreements to which the United States is a party. In obligating and expending the funds, the United States Trade Representative shall (1) give preference to initiatives that will create or sustain the greatest number of U.S. jobs or result in the greatest benefit to the U.S. economy; and (2) consider the needs of U.S. small and medium-sized businesses.

Effective Date

The effective date is the date of enactment of this legislation.

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[52] This section provided by the Office of the United States Trade Representative.

D. Promoting Small Business Fairness

1. Limitation on penalty for failure to disclose certain information (sec. 2041 of the bill and sec. 6707A of the Code)

Present Law

The reporting requirements of sections 6011 through 6112 create interlocking disclosure obligations for both taxpayers and advisors. Each of these disclosure statutes has a parallel penalty provision that enforces it. Prior to enactment of the American Jobs Creation Act of 2004 ("AJCA"),[53] no penalty was imposed on taxpayers who failed to disclose participation in transactions subject to section 6011. For disclosures that were due after enactment of that legislation, a strict liability penalty under section 6707A applies to any failure to disclose a reportable transaction.

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[54] A reportable transaction is defined as one that the Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[55] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[56]

Transactions falling under the first and last categories of reportable transactions are transactions that are described in publications issued by the Treasury Department and identified as one of these types of transaction. A listed transaction is defined as a reportable transaction which is the same as, or substantially similar[57] to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[58] A "transaction of interest" is one that is the same or substantially similar to a transaction identified by the Secretary as one about which the Secretary is concerned but does not yet have sufficient knowledge to determine that the transaction is abusive.[59]

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[53] Pub. L. No. 108-357.

[54] Treas. Reg. sec. 1.6011-4.

[55] Sec. 6707A(c)(1).

[56] Treas. Reg. sec. 1.6011-4(b)(2)-(6).

[57] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011-4(c)(4).

[58] Sec. 6707A(c)(2).

[59] Treas. Reg.sec. 1.6011-4(b)(6).

The other categories of reportable transactions are not specifically identified in published guidance, but are defined as classes of transactions sharing certain characteristics. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if an advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).[60] A transaction involves contractual protection if (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained, or (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[61] A reportable loss transaction generally includes any transaction that results in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[62] Treasury has announced its intention to add a sixth category of reportable transactions, patented transactions, but has not yet done so.[63]

Section 6707A imposes a penalty for failure to comply with the reporting requirements of 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under section 6011 by both the partnership and its partners.[64] The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is $100,000 for natural persons and $200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is $10,000 for natural persons and $50,000 for all other persons.

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the Securities and Exchange Commission ("SEC") for such periods specified by the Secretary. Disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[65] However, the taxpayer is only required to report the

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[60] Treas. Reg. sec. 1.6011-4(b)(3).

[61] Treas. Reg. sec. 1.6011-4(b)(4).

[62] Treas. Reg. sec. 1.6011-4(b)(5).

[63] Proposed Treas. Reg. sec. 1.6011-4(b)(7), published September 26, 2007 (REG-129916-07).

[64] See, e.g., Treas. Reg. sec. 1.6011-4(c)(3)(ii), Example 2.

[65] Sec. 6707A(e).

penalty one time. A public entity that is subject to a gross valuation misstatement penalty under section 6662(h) attributable to a non-disclosed listed transaction or non-disclosed reportable avoidance transaction may also be required to make disclosures in its SEC filings.[66]

For reportable transactions other than listed transactions, the Commissioner of the Internal Revenue ("Commissioner") or his delegate can rescind (or abate) the penalty only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.[67] The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. Determinations by the Commissioner regarding rescission are not subject to judicial review.[68] The Internal Revenue Service ("IRS") also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission. The section 6707A penalty cannot be waived with respect to a listed transaction.

The section 6707A penalty is assessed in addition to any accuracy-related penalties. If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable cause exception to the accuracy-related penalty is not available, and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[69] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[70] The Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[71]

<u>Explanation of Provision</u>

The provision changes the general rule for determining the amount of the applicable penalty to achieve proportionality between the penalty and the tax savings that were the object of the transaction, retains the current penalty amounts as the maximum penalty that may be imposed, and establishes a minimum penalty.

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[66] Sec. 6707A(e)(2)(C); Rev. Proc. 2005-51, 2005-2 CB 296.

[67] In determining whether to rescind (or abate) the penalty for failing to disclose a reportable transaction on the grounds that doing so would promote compliance with the tax laws and effective tax administration, it is intended that the Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

[68] This does not limit the ability of a taxpayer to challenge whether a penalty is appropriate (e.g., a taxpayer may litigate the issue of whether a transaction is a reportable transaction (and thus subject to the penalty if not disclosed) or not a reportable transaction (and thus not subject to the penalty)).

[69] Sec. 6662A(c).

[70] Sec. 6664(d).

[71] Sec. 6707A(d).

First, it provides a general rule that a participant in a reportable transaction who fails to disclose the reportable transaction as required under section 6011 is subject to a penalty equal to 75 percent of the reduction in tax reported on the participant's income tax return as a result of participation in the transaction, or that would result if the transaction were respected for federal tax purposes. Regardless of the amount determined under the general rule, the penalty for each such failure may not exceed certain maximum amounts. The maximum annual penalty that a taxpayer may incur for failing to disclose a particular reportable transaction other than a listed transaction is $10,000 in the case of a natural person and $50,000 for all other persons. The maximum annual penalty that a taxpayer may incur for failing to disclose a listed transaction is $100,000 in the case of a natural person and $200,000, for all other persons.

The provision also establishes a minimum penalty with respect to failure to disclose a reportable or listed transaction. That minimum penalty is $5,000 for natural persons and $10,000 for all other persons.

The following examples illustrate the operation of the maximum and minimum penalties with respect to a partnership or a corporation. First, assume that two individuals participate in a listed transaction through a partnership formed for that purpose. Both partners, as well as the partnership, are required to disclose the transaction. All fail to do so. The failure by the partnership to disclose its participation in a listed or otherwise reportable transaction is subject to the minimum penalty of $10,000, because income tax liability is not incurred at the partnership level nor reported on a partnership return. The partners in such partnership who also failed to comply with the reporting requirements of section 6011 are each subject to a penalty based on the reduction in tax reported on their respective returns.

In the second example, assume that a corporation participates in a single listed transaction over the course of three taxable years. The decrease in tax shown on the corporate returns is $1 million in the first year, $100,000 in the second year, and $10,000 in the third year. If the corporation fails to disclose the listed transaction in all three years, the corporation is subject to three separate penalties: a penalty of $200,000 in the first year (as a result of the cap on penalties), a $75,000 penalty in the second year (computed under the general rule) and a $10,000 penalty in the third year (as a result of the minimum penalty) for total penalties of $285,000.

Effective Date

The provision applies to all penalties assessed under section 6707A after December 31, 2006.

2. Temporary deduction for health insurance costs in computing self-employment income (sec. 2042 of the bill and sec. 162(l) of the Code)

Present Law

Deduction for health insurance premiums of self-employed individuals

In calculating adjusted gross income for income tax purposes, self-employed individuals may deduct the cost of health insurance for themselves and their spouses, dependents, and any children who have not attained age 27 as of the end of the taxable year.[72] The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan (maintained by the employer of the taxpayer or the taxpayer's spouse). Moreover, the deduction may not exceed the earned income (within the meaning of section 401(c)(2)) derived by the self-employed individual from the trade or business with respect to which the plan providing the health insurance coverage is established.[73] The deduction applies only to the cost of insurance (i.e., it does not apply to out-of-pocket expenses that are not reimbursed by insurance).

Self-Employment Contributions Act tax

The Self-Employment Contributions Act ("SECA") imposes taxes on the net earnings from self employment of self-employed individuals ("self-employment income"). The tax is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax; and (2) the hospital insurance ("HI") tax. The rate of the OASDI portion of SECA taxes is equal to 12.4 percent of self-employment income and generally applies to self-employment income up to the Federal Insurance Contributions Act ("FICA") taxable wage base ($106,800 in 2010). The rate of the HI portion is equal to 2.9 percent[74] of self-employment income and there is no cap on the amount of self-employment income to which the rate applies.[75] The deduction allowable for the cost of health insurance for the self-employed individual and the individual's spouse,

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[72] Sec. 162(l)(1). See Notice 2010-38 for a discussion of the deduction for children who have not attained age 27 as of the end of the taxable year.

[73] Sec. 162(l)(2).

[74] Sec. 1401. However, under section 9015 of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148), for remuneration and self-employment income received for taxable years beginning after December 31, 2012, the HI tax under SECA is increased by an additional tax of 0.9 percent on self-employment income received in excess of a threshold amount. However, unlike the general 1.45 percent HI tax on self-employment income, this additional tax is on the combined wages and self-employment income of the self-employed individual and spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

[75] For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

dependents, and children who have not attained age 27 as of the end of the taxable year for income taxes is not taken in account in determining an individual's net earnings from self employment for purposes of SECA taxes.[76]

Explanation of Provision

Under the provision, the deduction for income tax purposes allowed to self-employed individuals for the cost of health insurance for themselves, their spouses, dependents, and children who have not attained age 27 as of the end of the taxable year is taken into account, and thus also allowed, in calculating net earnings from self-employment for purposes of SECA taxes.

It is intended that earned income within the meaning of section 401(c)(2) be computed without regard to this deduction for the cost of health insurance.[77] Thus, earned income for purposes of the limitation applicable to the health insurance deduction is computed without regard to this deduction.

The provision only applies for the taxpayer's first taxable year beginning after December 31, 2009.

Effective Date

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

3. Remove cellular phones and similar telecommunications equipment from the definition of listed property (sec. 2043 of the bill and sec. 280F of the Code)

Present Law

Employer deduction

Property, including cellular telephones and similar telecommunications equipment (hereinafter collectively "cell phones"), used in carrying on a trade or business is subject to the general rules for deducting ordinary and necessary expenses under section 162. Under these rules, a taxpayer may properly claim depreciation deductions under the applicable cost recovery rules for only the portion of the cost of the property that is attributable to use in a trade or business.[78] Similarly, the business portion of monthly telecommunication service is generally deductible, subject to capitalization rules, as an ordinary and necessary expense of carrying on a trade or business.

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[76] Sec. 162(l)(4).

[77] A technical correction may be needed to achieve this result.

[78] Sec. 212 allows deductions for ordinary and necessary expenses paid or incurred for the production or collection of income.

In the case of certain listed property, special rules apply. Listed property generally is defined as (1) any passenger automobile; (2) any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment; (5) any cellular telephone (or other similar telecommunications equipment);[79] and (6) any other property of a type specified in Treasury regulations.[80]

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.[81] A taxpayer must substantiate the elements of each expenditure or use of listed property, including (1) the amount (e.g., cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (e.g., mileage for automobiles), and the total use of the property for the taxable period, (2) the date of the expenditure or use, and (3) the business purposes for the expenditure or use.[82] The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.[83]

With respect to the business use of listed property made available by an employer for use by an employee, the employer must substantiate that all or a portion of the use of the listed property is by employees in the employer's trade or business.[84] If any employee used the listed property for personal use, the employer must substantiate that it included an appropriate amount in the employee's income.[85] An employer generally may rely on adequate records maintained and retained by the employee or on the employee’s own statement if it is corroborated by other sufficient evidence, unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate.[86]

Cost recovery

A taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the

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[79] Cellular telephones (or other similar telecommunications equipment) were added as listed property as part of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7643 (1989).

[80] Sec. 280F(d)(4)(A).

[81] Sec. 274(d)(4).

[82] Temp. Reg. sec. 1.274-5T(b)(6).

[83] Temp. Reg. sec. 1.274-5T(c)(2)(ii)(C).

[84] Temp. Reg. sec. 1.274-5T(e)(2)((i)(A).

[85] *Ibid*.

[86] Temp. Reg. sec. 1.274-5T(e)(2)(ii). In Notice 2009-46, 2009-23 I.R.B. 1068, the Service requested comments regarding several proposals to simplify the procedures for employers to substantiate an employee's business use of certain employer-provide telecommunications equipment (including cellular telephones).

depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the taxpayer's depreciation deduction would be maximized.

In the case of certain listed property, special depreciation rules apply. First, if for the taxable year that the property is placed in service the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.[87] The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.[88] Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.[89]

Explanation of Provision

The provision removes cell phones from the definition of listed property. Thus, under the provision, the heightened substantiation requirements and special depreciation rules that apply to listed property do not apply to cell phones.[90]

Effective Date

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

[87] Sec. 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (i.e., included in gross income) for such taxable year.

[88] Sec. 168(g).

[89] Sec. 280F(d)(3).

[90] The provision does not affect Treasury's authority to determine the appropriate characterization of cell phones as a working condition fringe benefit under section 132(d) or that the personal use of such devices that are provided primarily for business purposes may constitute a de minimis fringe benefit, the value of which is so small as to make accounting for it administratively impracticable, under section 132(e).

II. REVENUE PROVISIONS

A. Reducing the Tax Gap

1. Information reporting for rental property expense payments(sec. 2101 of the bill and sec. 6041 of the Code)

Present Law

A variety of information reporting requirements apply under present law.[91] The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments to any one payee aggregating $600 or more in any taxable year in the course of that payor's trade or business.[92] Reportable payments include compensation for both goods and services, and may include gross proceeds. Certain enumerated types of payments that are subject to other specific reporting requirements are carved out of reporting under this general rule.[93]

One such regulatory exception carved out payments to corporations,[94] but was expressly overridden by the addition of new section 6041(h) by section 9006 of the Patient Protection and Affordable Health Care Act ("PPACA").[95] New section 6041(h) expanded information reporting requirements to include gross proceeds paid in consideration for property and to subject payments to corporations to all of the reporting requirements under section 6041. The payor is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.[96] The regulations generally except from

[91] Secs. 6031 through 6060.

[92] Sec. 6041(a). The information return is generally submitted electronically as a Form 1096 and Form 1099, although certain payments to beneficiaries or employees may require use of Forms W-3 and W-2, respectively. Treas. Reg. sec. 1.6041-1(a)(2).

[93] Sec. 6041(a) requires reporting "other than payments to which section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a) or 6050N(a) applies and other than payments with respect to which a statement is required under authority of section 6042(a), 6044(a)(2) or 6045[.]" The payments thus excepted include most interest, royalties, and dividends.

[94] Treas. Reg. sec. 1.6041-3(p).

[95] Pub. L. No. 111-148, sec. 9006 (effective for payments made after December 31, 2011).

[96] Sec. 6041(d). Specifically, the recipient of the payment is required to provide a Form W-9 to the payor, which enables the payee to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor. If a Form W-9 is not provided, the payor is required to "backup withhold" tax at a rate of 28 percent of the gross amount of the payment unless the payee has otherwise established that the income is exempt from backup withholding. The backup withholding tax may be credited by the payee against regular income tax liability, i.e., it is effectively an advance payment of tax, similar to the withholding of tax from wages. This combination of reporting and backup withholding is designed to ensure that U.S. persons pay an appropriate amount of tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

reporting payments to exempt organizations, governmental entities, international organizations, or retirement plans.[97] Additionally, the requirement that businesses report certain payments is not applicable to persons engaged in a passive investment activity. Thus, a taxpayer whose rental real estate activity is a trade or business is subject to this reporting requirement, but a taxpayer whose rental real estate activity is not considered a trade or business is not subject to such requirement.

In addition, financial institutions are required to report to both taxpayers and the IRS the amount of interest taxpayers paid during the year on mortgages they held on their rental properties.[98]

A person that fails to comply with the information reporting requirements is subject to penalties, which may include a penalty for failure to file the information return,[99] for failure to furnish payee statements,[100] or for failure to comply with other various reporting requirements.[101]

Explanation of Provision

Under the provision, recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making payments of $600 or more to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income are required to provide an information return (typically Form 1099-MISC) to the IRS and to the service provider. Exceptions to this reporting requirement are made for (i) members of the military or employees of the intelligence community (as defined in section 121(d)(9)) who rent their principal residence on a temporary basis, (ii) individuals who receive only minimal amounts of rental income, as determined by the Secretary in accordance with regulations, and (iii) individuals for whom the requirements would cause hardship, as determined by the Secretary in accordance with regulations.

Effective Date

The provision applies to payments made after December 31, 2010.

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[97] Treas. Reg. sec. 1.6041-3(p).

[98] Sec. 6050H. This information is provided on Form 1098.

[99] Sec. 6721. The penalty for the failure to file an information return generally is $50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed $250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

[100] Sec. 6722. The penalty for failure to provide a correct payee statement is $50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed $100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

[101] Sec. 6723. The penalty for failure to timely comply with a specified information reporting requirement is $50 per failure, not to exceed $100,000 for a calendar year.

2. Increase in information return penalties (sec. 2102 of bill and secs. 6721 and 6722 of the Code)

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721, any person who is required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the "second-tier penalty"), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return (the "third-tier penalty"), with a maximum penalty of $250,000 per calendar year. If a failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is $100, with no calendar year limit.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 imposes penalties for failing to furnish correct payee statements to taxpayers. The penalty amount is $50 for each failure to furnish a payee statement, up to a maximum of $100,000. If the failure is due to intentional disregard, the amount of the penalty per failure is increased[102] and the cap on the penalty is not applicable. In addition, section 6723 imposes a penalty of $50 for failing to comply with other information reporting requirements, up to a maximum of $100,000.

Explanation of Provision

The provision amends section 6721 to increase the first-tier penalty from $15 to $30, and increase the calendar year maximum from $75,000 to $250,000. The second-tier penalty is increased from $30 to $60, and the calendar year maximum is increased from $150,000 to $500,000. The third-tier penalty is increased from $50 to $100, and the calendar year maximum

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[102] Sec. 6722(c)(1) provides that the penalty per failure is the greater of $100 or a fixed percentage of the aggregate items to be shown on the payee statements. The fixed amount is 10 percent for statements other than those required under sections 6045(b), 6041A(e), 6050H(d), 6050J(e), 6050K(b), or 6050L(c). The penalty is the greater of $100 or five percent of the amount required to be shown on statements required under sections 6045(b), 6050K(b) or 6050L(c).

is increased from $250,000 to $1,500,000. For small business filers, the calendar year maximum is increased from $25,000 to $75,000 for the first-tier penalty, from $50,000 to $200,000 for the second-tier penalty, and from $100,000 to $500,000 for the third-tier penalty. The minimum penalty for each failure due to intentional disregard is increased from $100 to $250.

The penalty for failure to furnish a payee statement is revised to provide tiers and caps similar to those applicable to the penalty for failure to file the information return. A first-tier penalty is $30, subject to a maximum of $250,000; a second-tier penalty is $60 per statement, up to $500,000, and the third -tier penalty is $100, up to a maximum of $1,500,000. The penalty is also amended to provide limitations on penalties for small businesses and increased penalties for intentional disregard that parallel the penalty for failure to furnish information returns.

Both the failure to file and failure to furnish penalties will be adjusted to account for inflation every five years with the first adjustment to take place after 2012, effective for each year thereafter.

Effective Date

The provision applies with respect to information returns required to be filed on or after January 1, 2011.

3. Annual reports on penalties and certain other enforcement actions (sec. 2103 of the bill)

Present Law

Transactions that have the potential for tax avoidance are required to be disclosed by both the taxpayers who engage in the transaction and the various professionals who provide advice with respect to such transactions. Failure to comply with the reporting and disclosure requirements may result in assessment of penalties against both the taxpayer and material advisor and the use of special enforcement measures.

Reporting obligations

These disclosure requirements[103] create interlocking disclosure obligations for both taxpayers and advisors. A taxpayer is required to disclose with its tax return certain information with respect to each "reportable transaction," as defined in regulations.[104] Each advisor who provides material advice with respect to any reportable transaction (including any listed transaction) is required to file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[105] Finally, the advisor is required to maintain a list of those

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[103] Secs. 6011, 6111 and 6112.

[104] Treas. Reg. sec. 1.6011-4.

[105] Sec. 6111.

persons he has advised with respect to a reportable transaction and to provide the list to the IRS upon request.[106]

A reportable transaction is defined as one that the Secretary requires to be disclosed based on its potential for tax avoidance or evasion.[107] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[108]

Penalties and other enforcement tools related to reportable transactions

Each of the disclosure statutes has a parallel penalty provision to aid enforcement. The taxpayer who participates in a reportable transaction and fails to disclose it is subject to a strict liability penalty.[109] The penalty is assessed in addition to any accuracy-related penalties. It may be rescinded with respect to reportable transactions other than listed transactions. Rescission is discretionary and conditioned upon a determination by the Commissioner that rescinding the penalty would promote compliance and effective tax administration.[110] The Code also imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction). It may be rescinded, subject to limitations similar to those applicable to rescission of the penalty imposed on investors.[111] The IRS may also submit a written request that a

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[106] Sec. 6112.

[107] Sec. 6707A(c)(1) states that the term means "any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." Sections 6111(b)(2) and 6112 both define "reportable transaction" by reference to the definition in section 6707A(c). The definition of "listed transaction" similarly depends upon identification of transactions by the Secretary as tax avoidance transactions for purposes of section 6011.

[108] Treas. Reg. sec. 1.6011-4(b)(2)-(6).

[109] Section 6707A imposes a penalty for failure to comply with the reporting requirements of section 6011. A single reportable transaction may have to be reported by multiple taxpayers in connection with multiple tax returns. For example, a reportable transaction entered into by a partnership may have to be reported under section 6011 by both the partnership and its partners.[109] The amount of the penalty due for each taxpayer's failure to comply varies depending upon whether or not the transaction is a listed transaction and whether the relevant taxpayer is an individual. For listed transactions, the maximum penalty is $100,000 for natural persons and $200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is $10,000 for natural persons and $50,000 for all other persons. A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods specified by the Secretary. Failure to comply with this reporting requirement may result in assessment of a second tier penalty.

[110] Sec. 6707A(d). In determining whether to rescind (or abate) the penalty for failing to disclose a reportable transaction on the grounds that doing so would promote compliance with the tax laws and effective tax administration, it is intended that the Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

[111] Section 6707 provides a penalty in the amount of $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross

material advisor make available the list required to be maintained under section 6612(a). A failure to make the list available upon written request is subject to a penalty of $10,000 per day for as long as the failure continues, unless the advisor can establish reasonable cause for the failure. [112]

In addition to the penalties that specifically address the failure to comply with the disclosure and reporting obligations, other special enforcement provisions are applicable to reportable transactions. An understatement arising from any listed transactions or from a reportable transaction for which a significant purpose is avoidance or evasion of Federal income tax will be subject to an accuracy-related penalty,[113] unless the taxpayer can establish that the failure was due to reasonable cause as determined under a standard that is more stringent than that applicable to other accuracy-related penalties.[114]

If the taxpayer does not adequately disclose a reportable transaction, the strengthened reasonable cause exception is not available and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[115] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[116] Finally, a new exception to the statute of limitations provides that the period is suspended if a listed transaction is not properly disclosed.[117] If the transaction is disclosed either because the taxpayer files the proper disclosure form or a material advisor identifies the transaction to the IRS in a list maintained under section 6112, the period will remain open for at least one year from the earlier of date of the disclosure by the investor or the disclosure by the material advisor with respect to that transaction.

The Code authorizes civil actions to enjoin any person from specified conduct relating to tax shelters or reportable transactions.[118] The specified conduct includes failure to comply with respect to the requirements relating to the reporting of reportable transactions[119] and the keeping

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income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

[112] Sec. 6708.

[113] Sec. 6662A.

[114] Sec. 6664(d).

[115] Sec. 6662A(c).

[116] Sec. 6664(d).

[117] Sec. 6501(c)(10).

[118] Sec. 7408.

[119] Sec. 6707.

of lists of investors by material advisors.[120] Thus, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction. In addition, injunctions, monetary penalties and suspension or disbarment are authorized with respect to violations of any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

Reports to Congress by the Secretary

The Secretary is required to maintain records and report on the administration of the penalties for failure to disclose a reportable transaction in two ways. First, each decision to rescind a penalty imposed under section 6707 or section 6707A must be memorialized in a record maintained in the Officer of the Commissioner.[121] That record must include a description of the facts and circumstances of the violation, the reasons for the decision to rescind, and the amount rescinded. Second, the IRS is required to submit an annual report to Congress on the administration of the rescission authority under both sections 6707 and 6707A. The information with respect to the latter is to be in summary form, while the information on rescission of penalties imposed against material advisors is to be more detailed.[122] The report is not required to address administration of the other enforcement tools described above.

Explanation of Provision

The provision requires that the IRS, in consultation with the Secretary, submit an annual report on administration of certain penalty provisions of the Code to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. A summary of penalties assessed the preceding year is required. In addition, the Secretary must report actions taken against practitioners appearing before the Treasury or IRS with respect to a reportable transaction[123] and instances in which the IRS attempted to rely on the exception to the limitations period for assessment based on failure to disclose a listed transaction.[124] The

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[120] Sec. 6708.

[121] Section 6707(c) incorporates by reference the provisions of section 6707A(d), which details the extent of the Commissioner's authority to rescind the penalty.

[122] AJCA provides:
"The Commissioner of Internal Revenue shall annually report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate--
"(1) a summary of the total number and aggregate amount of penalties imposed, and rescinded, under section 6707A of the Internal Revenue Code of 1986, and
"(2) a description of each penalty rescinded under section 6707(c) of such Code and the reasons therefor." P.L. No. 108-357, Title VIII, Subtitle B, Part I, § 811(d), 118 Stat. 1577, Oct. 22, 2004.

[123] 31 U.S.C. sec. 330(b) authorizes the Secretary to impose sanctions on those who appear before the Department, including monetary penalties and suspension or disbarment from practice before the Department.

[124] Sec. 6501(c)(10) provides that the limitations period with respect to tax attributable to a listed transaction shall not expire less than one year after the required disclosure of that transaction is furnished by the taxpayer or by the material advisor, whichever is earlier.

penalties that are subject to this reporting requirement are those assessed in the preceding year with respect to (1) a participant's failure to disclose a reportable transaction,[125] (2) reportable transaction understatements,[126] (3) promotion of abusive shelters,[127] (4) failure of a material advisor to furnish information on a reportable transaction,[128] and (5) material advisors' failure to maintain or produce a list of reportable transactions.[129]

Effective Date

The first annual report is required to be submitted not later than December 31, 2010.

4. Application of continuous levy to employment tax liability of certain Federal contractors (sec. 2104 of the bill and sec. 6330 of the Code)

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property or rights to property to pay the taxpayer's tax liability.[130] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[131] and the IRS has provided both notice of intention to levy[132] and notice of the right to an administrative hearing (referred to as a collections due process notice or "CDP" notice)[133] at least thirty days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[134]

The 30-day pre-levy notice requirements, the taxpayer's rights before, during, and following the CDP hearing, and the Federal payment levy program are discussed below.

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[125] Sec. 6707A.

[126] Sec. 6662A.

[127] Sec. 6700.

[128] Sec. 6707.

[129] Sec. 6708.

[130] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[131] Sec. 6331(a).

[132] Sec. 6331(d).

[133] Sec. 6330. The administrative hearing is referred to as the CDP hearing.

[134] Secs. 6321 and 6331(a).

Pre-levy notice requirements

The notice of intent to levy and the CDP notice must include a brief statement describing the following: (1) the statutory provisions and procedures for levy; (2) the administrative appeals available to the taxpayer; (3) the alternatives available to avoid levy; and (4) the provisions and procedures regarding redemption of levied property.[135] In addition, the collection due process notice must include the following: (1) the amount of the unpaid tax; and (2) the right to request a hearing during the 30-day period before the IRS serves the levy.

Upon receipt of this information, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office.[136] Otherwise, the IRS will levy to collect the amount owed after expiration of 30 days from the notice.

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable in permitting the IRS to assess a tax without following the normal deficiency procedures.[137]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund. In addition, a levy issued to collect Federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. The taxpayer, however, in each of these three cases, is provided an opportunity for a hearing within a reasonable period of time after the levy.[138]

CDP hearing

At the CDP hearing, the taxpayer may present defenses to collection as well as arguments disputing the merits of the underlying tax debt if the taxpayer had no prior opportunity to present such arguments.[139] In addition, the taxpayer is required to be provided the opportunity to negotiate an alternative form of payment, such as an offer-in-compromise, under which the IRS would accept less than the full amount, or an installment agreement under which payments in satisfaction of the debt may be made over time rather than in one lump sum, or some

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[135] Secs. 6330(a)(3) and 6331(d)(4). In practice, the notice of intent to levy and the collections due process notice is provided together in one document, Letter 1058, *Final Notice, Notice of Intent to Levy and Notice of Your Right to a Hearing*. Chief Counsel Advice Memorandum 2009-041 (November 28, 2008).

[136] Sec. 6330(b).

[137] Secs. 6331(d)(3) and 6861.

[138] Sec. 6330(f).

[139] Sec. 6330(c).

combination of such measures.[140] If a taxpayer exercises any of these rights in response to the notice of intent to levy, the IRS may not proceed with its levy.

After the CDP hearing, a taxpayer also has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination.[141] During this time period, the IRS may not proceed with its levy.

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[142] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to Federal contractors that are delinquent on their tax obligations. The levy generally continues in effect until the liability is paid or the IRS releases the levy.[143]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and Federal wage records. When the records match, the delinquent taxpayer is provided both notice of intention to levy and notice of the right to the CDP hearing 30 days before the levy is made. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy its Federal payments. Subsequent payments are continuously levied until the tax debt is paid or IRS releases the levy.

Upon receipt of this information, however, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office. Following the CDP hearing, a taxpayer has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination. During this time period, the IRS may not proceed with its levy.

Explanation of Provision

The provision allows the IRS to issue levies prior to a CDP hearing with respect to Federal tax liabilities of Federal contractors identified under the Federal Payment Levy Program. When a levy is issued prior to a CDP hearing under this proposal, the taxpayer has an opportunity for a CDP hearing within a reasonable time after the levy.

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[140] Sec. 6330(c)(2).

[141] Sec. 6330(d).

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

[143] Sec. 6331(h). With respect to Federal payments to vendors of goods or services (not defined), the continuous levy may be up to 100 percent of each payment. Sec. 6331(h)(3).

Effective Date

The provision applies to levies issued after the date of enactment.

B. Promoting Retirement Preparation

1. Allow participants in government section 457 plans to treat elective deferrals as Roth contributions (sec. 2111 of the bill and sec. 402A of the Code)

Present Law

Section 401(k) plans and section 403(b) plans are permitted to have qualified Roth contribution programs under which participants may elect to make non-excludable contributions to "designated Roth accounts" and, if certain conditions are met, to exclude from gross income distributions from these accounts.

A qualified Roth contribution program is a program under which a participant may elect to make designated Roth contributions in lieu of all or a portion of the elective deferrals that he or she otherwise would be eligible to make under the applicable retirement plan. To qualify as a qualified Roth contribution program a plan must: (1) establish a separate designated Roth account for the designated Roth contributions of each participant (and for the earnings allocable to these contributions); (2) maintain separate records for each account; and (3) refrain from allocating to the designated Roth account amounts from non-designated Roth accounts.

Generally, if an "applicable retirement plan" includes a qualified Roth contribution program then any contribution that a participant makes under the program is treated as an "elective deferral," but is not excludable from gross income.[144] For purposes of the qualified Roth contribution program rules, the term "applicable retirement plan" means: (1) an employee trust described in section 401(a) which is tax-exempt under section 501(a);[145] and (2) a plan under which amounts are contributed by an individual's employer for a section 403(b) annuity contract.[146] An "elective deferral" is any deferral described in: (1) section 402(g)(3)(A) (employer contributions to section 401(k) plans not includible in employee's gross income); or (2) section 402(g)(3)(C) (employer contributions to purchase an annuity contract under a section 403(b) salary reduction agreement).

Explanation of Provision

The provision amends the definition of "applicable retirement plan" to include eligible deferred compensation plans (as defined under section 457(b)) maintained by a State, a political subdivision of a State, an agency or instrumentality of a State, or an agency or instrumentality of a political subdivision of a State (collectively, "governmental 457(b) plans"). The provision also amends the definition of "elective deferral" in section 402A to include amounts deferred under governmental 457(b) plan.

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[144] Sec. 402A(a)(1).

[145] That is, a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries.

[146] That is, an annuity purchased by a section 501(c)(3) organization or a public school.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

2. Allow rollovers from elective deferral plans to Roth designated accounts (sec. 2112 of the bill and sec. 402A of the Code)

Present law

Individual retirement arrangements

General rules

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[147] to which both deductible and nondeductible contributions may be made,[148] and Roth IRAs, to which only nondeductible contributions may be made.[149] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income. For a Roth IRA, all contributions are after-tax (no deduction is allowed) but, if certain requirements are satisfied, distributions are not includable in gross income.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth IRAs) for a taxable year is the lesser of a certain dollar amount ($5,000 for 2010)[150] or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by $1,000. Thus for example, if an individual over age 50 contributes $6,000 to a Roth IRA for 2010 ($5,000 plus $1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for the year. In addition, deductible contributions to traditional IRAs and after tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

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[147] Sec. 408.

[148] Sec. 219.

[149] Sec. 408A.

[150] The dollar limit is indexed for inflation.

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2010 are: (1) for single taxpayers, $109,000 to $124,000; (2) for married taxpayers filing joint returns, $167,000 to $177,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70-½.

Taxpayers generally may convert a traditional IRA into a Roth IRA.[151] A conversion may be accomplished by means of a rollover, trustee-to-trustee transfer, or account redesignation. Regardless of the means used to convert, any amount converted from a traditional IRA to a Roth IRA is treated as distributed from the traditional IRA and rolled over to the Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. Under special ordering rules, after-tax contributions are recovered before income.[152] The amount includible in income is also subject to the 10-percent early withdrawal tax unless an exception applies. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

Cash or deferred arrangements

Section 401(k) plans and section 403(b) plans

A qualified retirement plan[153] that is a profit-sharing plan may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement. A plan with this feature is generally referred to as a section 401(k)

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[151] For taxable years beginning before January 1, 2010, such a conversion is not permitted to be made by a taxpayer whose modified adjusted gross income for the year of the distribution exceeds $100,000 (or who, if married, does not file jointly). For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed $100,000 (and who, if married, files jointly).

[152] Sec. 408A(d)(4).

[153] Qualified retirement plans include plans qualified under section 401(a) and section 403(a) annuity plans.

plan. A section 403(b) plan may allow a similar salary reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.[154] Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements generally are referred to as elective contributions and generally are excludable from gross income. There is a dollar limit on the aggregate amount of elective contributions that an employee is permitted to be contribute to either of these plans for a taxable year which is $16,500 for 2010. There is an additional catch up amount that employees over age 50 are allowed to contribute which is $5,500 for 2010.

Elective contributions under a section 401(k) plan are subject to distribution restrictions under the plan. Such contributions generally may only be distributed after attainment of age 59-½, death of the employee, termination of the plan, or severance from employment with the employer maintaining the plan. These contributions are also permitted to be distributed on account of hardship. These limitations also apply to certain other contributions to the plan except that such distributions cannot be distributed on account of hardship. Similar distribution restrictions apply to salary reduction contributions under section 403(b) plans.

Amounts under a profit sharing plan that are not subject to these specific distribution restrictions are distributable only as permitted under the plan terms. In order to meet the definition of profit-sharing plan, the plan may allow distribution of an amount contributed to a profit sharing plan after a fixed number of years (but not less than two).[155]

Designated Roth accounts

A qualified retirement plan or a section 403(b) plan with a cash or deferred arrangement can include a Designated Roth program under which an employee is permitted to designate any elective contribution as a designated Roth contribution in lieu of making a pre-tax elective contribution. Although such a plan is permitted to offer only the opportunity to make pre-tax elective contributions, a plan that allows designated Roth contributions must offer a choice of both pre-tax elective contributions and designated Roth contributions.[156] The designated contributions are generally treated the same under the plan as pre-tax elective contributions (e.g. the nondiscrimination requirements and contribution limits) except a designated Roth contribution is not excluded from gross income.

All designated Roth contributions made under the plan must be maintained in a separate account (a designated Roth account). Any distribution from a designated Roth account (other than a qualified distribution) is taxable under section 402 by treating the designated Roth account as a separate contract for purpose of section 72. The distribution is included in the distributee's gross income to the extent allocable to income under the contract and excluded from gross

[154] Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.

[155] Rev. Rul. 71-295, 1971, CB 184 and Treas. Reg. sec. 1.401(b)(1)(ii).

[156] Treas. Reg. sec.1.401(k)-1(f)(1)(i).

income to the extent allocable to investment in the contract (commonly referred to as basis), taking into account only the designated Roth contributions as basis. The special basis-first recovery rule for Roth IRAs does not apply to distributions from designated Roth accounts.

A qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is a distribution that is made after completion of a specified 5-year period and the satisfaction of one of three other requirements. The three other requirements are the same as the other requirements for a qualified distribution from a Roth account except that the first-time home buyer provision does not apply.

Eligible rollover distributions from designated Roth accounts may only be rolled over tax free to another designated Roth account or a Roth IRA.

Rollovers from eligible retirement plans

An eligible rollover distribution from an eligible employer plan that is not from a designated Roth account may be rolled over to an eligible retirement plan that is not a Roth IRA or a designated Roth account. An eligible employer plan is a qualified retirement plan, a section 403(b) plan; and a "governmental section 457(b) plan."[157] In such a case, the distribution generally is not currently includible in the distributee's gross income. An eligible retirement plan means an individual retirement plan or an eligible employer plan. An eligible rollover distribution is any distribution from an eligible employer plan with certain exceptions. Distributions that are not eligible rollover distributions generally are certain periodic payments, any distribution to the extent the distribution is a minimum required distribution, and any distribution made on account of hardship of the employee.[158] Only an employee or a surviving spouse of an employee is allowed to rollover an eligible rollover distribution from an eligible employer plan to another eligible employer plan.[159]

Distributions from an eligible employer plan are also permitted to be rolled over into a Roth IRA, subject to the present law rules that apply to conversions from a traditional IRA into a Roth IRA.[160] Thus, a rollover from an eligible employer plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply.[161] In the case of a distribution and rollover of

[157] A governmental section 457(b) plan is an eligible section 457(b) plan maintained by a governmental employer described in section 457(e)(1)(A).

[158] Sec. 402(c)(4).

[159] Section 402(c)(10) allows nonspouse beneficiaries to make a direct rollover to an IRA but not another eligible employer plan.

[160] For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed $100,000 (and who, if married, files jointly).

[161] Prior to enactment of section 824 of the Pension Protection Act of 2006, Public Law 109-280 (120 Stat. 780) (PPA '06), an eligible rollover distribution from an eligible employer plan not made from a designated Roth account could be rolled over to a non-Roth IRA and then converted to a Roth IRA, but could not be rolled over to a

property, the amount of the distribution for purposes of determining the amount includable in gross income is generally the fair market value of the property on the date of the distribution.[162] The special rules relating to net unrealized appreciation and certain optional methods for calculating tax available to participants born on or before January 1, 1936 are not applicable.[163] A special recapture rule relating to the 10-precent additional tax on early distributions applies for distributions made from a Roth IRA within a specified five-year period after a rollover. [164]

Special rule for 2010 conversions or rollovers

In the case of a rollover from a tax-qualified retirement plan (other than a designated Roth account) into a Roth IRA, unless the taxpayer elects to include the distribution in income in 2010, any amount otherwise required to be included in gross income for the 2010 taxable year is not included in that taxable year but is instead included in gross income in equal amounts for the 2011 and 2012 taxable years. The same rule applies to a conversion of a traditional IRA into a Roth IRA in 2010. However, in both cases, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from a Roth IRA within a specified five-year period after a rollover.

Explanation of Provision

Under the provision, if a section 401(k) plan, section 403(b) plan, or governmental section 457(b) plan[165] has a qualified designated Roth contribution program, a distribution to an employee (or a surviving spouse) from an account under the plan that is not a designated Roth account is permitted to be rolled over into a designated Roth account under the plan for the individual. However, a plan that does not otherwise have a designated Roth program is not permitted to establish designated Roth accounts solely to accept these rollover contributions. Thus, for example, a qualified employer plan that does not include a qualified cash or deferred arrangement with a designated Roth program cannot allow rollover contributions from accounts that are not designated Roth accounts to designated Roth accounts established solely for purposes of accepting these rollover contributions. Further, the distribution to be rolled over must be otherwise allowed under the plan. For example, an amount under a section 401(k) plan subject to distribution restrictions cannot be rolled over to a designated Roth account under this provision. However, if an employer decides to expand its distribution options beyond those currently allowed under its plan, such as by adding in-service distributions or distributions prior to normal retirement age, in order to allow employees to make the rollover contributions permitted under this provision, the plan may condition eligibility for such a new distribution

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Roth IRA without an intervening rollover to a non-Roth IRA followed by a conversion to a Roth IRA. See Notice 2008-30, 2008-12 I.R.B. 638.

[162] Treas. Reg. sec. 1.402(a)-1(a)(iii).

[163] Notice 2009-75, 2009-39 IRB 436.

[164] Sec. 408A(d)(3)(F), Treas. Reg. sec. 1.408A-6 A-5, and Notice 2008-30, Q&A-3.

[165] The bill includes a provision which adds governmental section 457(b) plans to the plans that are permitted to include a designated Roth program. See explanation of section 211 of the bill.

option on an employee's election to have the distribution directly rolled over to the designated Roth program within that plan.

In the case of a permitted rollover contribution to a designated Roth account under this provision, the individual must include the distribution in gross income (subject to basis recovery) in the same manner as if the distribution were rolled over into a Roth IRA. Thus the special rule for distributions from eligible retirement plans (other than from designated Roth accounts) that are contributed to a Roth IRA in 2010 applies for these rollover contributions to a designated Roth account. Under this special rule, the taxpayer is allowed to include the amount in income in equal parts in 2011 and 2012. The special recapture rule for the 10-percent early distribution tax also applies if distributions are made from the designated Roth account in the relevant five year period.

This rollover contribution may be accomplished at the election of the employee (or surviving spouse) through a direct rollover (operationally through a transfer of assets from the account that is not a designated Roth account to the designated Roth account). However, such a direct rollover is only permitted if the employee (or surviving spouse) is eligible for a distribution in that amount and in that form (if property is transferred) and the distribution is an eligible rollover distribution. If the direct rollover is accomplished by a transfer of property to the designated Roth account (rather than cash), the amount of the distribution is the fair market value of the property on the date of the transfer.

A plan that includes a designated Roth program is permitted but not required to allow employees (and surviving spouses) to make the rollover contribution described in this provision to a designated Roth account. If a plan allows these rollover contributions to a designated Roth account, the plan must be amended to reflect this plan feature. It is intended that the IRS will provide employers with a remedial amendment period that allows the employers to offer this option to employees (and surviving spouses) for distributions during 2010 and then have sufficient time to amend the plan to reflect this feature.[166]

Effective Date

The provision is effective for distributions made after the date of enactment.

[166] See section 401(b), Treas. Reg. sec 1.401(b)-1, and Rev. Proc. 2007-44, 2007-2 CB 54, regarding remedial amendment periods for plan amendments.

3. Permit partial annuitization of a nonqualified annuity contract (sec. 2113 of the bill and sec. 72 of the Code)

Present Law

Treatment of annuity contracts

In general, earnings and gains on a deferred annuity contract are not subject to tax during the deferral period in the hands of the holder of the contract.[167] When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received as an annuity (generally, as periodic payments under contract terms) or not.[168]

For amounts received as an annuity by an individual, an exclusion ratio is provided for determining the taxable portion of each payment.[169] The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract. Section 72 uses the term "investment in the contract" in lieu of the more generally applicable term "basis."

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date, and are included in income to the extent allocable to income on the contract if received before the annuity starting date (i.e., as income first).[170]

Specific rules for recovering the investment in the contract for amounts received as an annuity are provided for plans qualified under section 401(a), plans described in section 403(a),

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[167] If an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[168] Sec. 72.

[169] Sec. 72(b).

[170] Sec. 72(e). By contrast to distributions under an annuity contract, distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

and section 403(b) tax-deferred annuities.[171] In addition, specific rules apply to amounts not received as an annuity under these plans and individual retirement plans.[172]

Tax-free exchanges of annuity contracts

Present law provides for the exchange of certain insurance contracts without recognition of gain or loss.[173] No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract or for a qualified long-term care insurance contract; or (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract or for a qualified long-term care insurance contract; (3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or (4) a qualified long-term care insurance contract for a qualified long-term care insurance contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged.[174]

In interpreting section 1035, case law holds that an exchange of a portion of an annuity contract for another annuity contract qualifies as a tax-free exchange.[175] Treasury guidance provides rules for determining whether a direct transfer of a portion of the cash surrender value of an annuity contract for a second annuity contract qualifies as a section 1035 tax-free exchange. Under the Treasury guidance, either the annuity contract received, or the contract partially exchanged, in the tax-free exchange may be annuitized without jeopardizing the tax-free exchange (or amounts withdrawn from it or received in surrender of it) after the period ending 12 months from the receipt of the premium in the exchange.[176]

Explanation of Provision

The provision permits a portion of an annuity, endowment, or life insurance contract to be annuitized while the balance is not annuitized, provided that the annuitization period is for 10 years or more, or is for the lives of one or more individuals.

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[171] Sec. 72(d).

[172] Sec. 72(e)(8).

[173] Sec. 1035.

[174] Sec. 1031(d).

[175] *Conway v. Comm'r*, 111 T.C. 350 (1998), *acq*., 1999-2 C.B. xvi.

[176] Rev. Proc. 2008-24, 2008-13 I.R.B. 684. The Rev. Proc. further provides that a transfer does not, however, qualify as a tax-free exchange if the payment is a distribution that is part of a series of substantially equal periodic payments, or if the payment is a distribution under an immediate annuity. The Treasury guidance further provides that if a direct transfer of a portion of an annuity contract for a second annuity contract does not qualify as a tax-free exchange under section 1035, it is treated as a taxable distribution followed by a payment for the second contract.

The provision provides that if any amount is received as an annuity for a period of 10 years or more, or for the lives of one or more individuals, under any portion of an annuity, endowment, or life insurance contract, then that portion of the contract is treated as a separate contract for purposes of section 72.

The investment in the contract is allocated on a pro rata basis between each portion of the contract from which amounts are received as an annuity and the portion of the contract from which amounts are not received as an annuity. This allocation is made for purposes of applying the rules relating to the exclusion ratio, the determination of the investment in the contract, the expected return, the annuity starting date, and amounts not received as an annuity.[177] A separate annuity starting date is determined with respect to each portion of the contract from which amounts are received as an annuity.

The provision is not intended to change the present-law rules with respect either to amounts received as an annuity, or to amounts not received as an annuity, in the case of plans qualified under section 401(a), plans described in section 403(a), section 403(b) tax-deferred annuities, or individual retirement plans.

Effective Date

The provision is effective for amounts received in taxable years beginning after December 31, 2010.

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[177] Secs. 72(b), (c), and (e).

C. Closing Unintended Loopholes

1. Make crude tall oil ineligible for the cellulosic biofuel producer credit (sec. 2121 of the bill and sec. 40 of the Code)

Present Law

The "cellulosic biofuel producer credit" is a nonrefundable income tax credit for each gallon of qualified cellulosic biofuel production of the producer for the taxable year. The amount of the credit is generally $1.01 per gallon.[178]

"Qualified cellulosic biofuel production" is any cellulosic biofuel which is produced by the taxpayer and which is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified cellulosic biofuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or (c) who sells such cellulosic biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).

"Cellulosic biofuel" means any liquid fuel that (1) is produced in the United States and used as fuel in the United States, (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act. The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of cellulosic biofuel.

Cellulosic biofuel does not include certain unprocessed fuel. Unprocessed fuels are fuels which (1) are more than four percent (determined by weight) water and sediment in any combination, or (2) have an ash content of more than one percent (determined by weight).[179] Cellulosic biofuel eligible for the section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.[180]

Because it is a credit under section 40(a), the cellulosic biofuel producer credit is part of the general business credits in section 38. However, unlike other general business credits, the

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[178] In the case of cellulosic biofuel that is alcohol, the $1.01 credit amount is reduced by the credit amount of the alcohol mixture credit, and for ethanol, the credit amount for small ethanol producers, as in effect at the time the cellulosic biofuel fuel is produced.

[179] Water content (including both free water and water in solution with dissolved solids) is determined by distillation, using for example ASTM method D95 or a similar method suitable to the specific fuel being tested. Sediment consists of solid particles that are dispersed in the liquid fuel and is determined by centrifuge or extraction using, for example, ASTM method D1796 or D473 or similar method that reports sediment content in weight percent. Ash is the residue remaining after combustion of the sample using a specified method, such as ASTM D3174 or a similar method suitable for the fuel being tested.

[180] See sections 40A(d)(1), 40A(f)(3), and 6426(h).

cellulosic biofuel producer credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under section 87, the credit is included in gross income. The cellulosic biofuel producer credit terminates on December 31, 2012.

The kraft process for making paper produces a byproduct called black liquor, which has been used for decades by paper manufacturers as a fuel in the papermaking process. Black liquor is composed of water, lignin and the spent chemicals used to break down the wood. The amount of the biomass in black liquor varies. The portion of the black liquor that is not consumed as a fuel source for the paper mills is recycled back into the papermaking process. Black liquor has ash content (mineral and other inorganic matter) significantly above that of other fuels.

Crude tall oil is generated by reacting acid with black liquor soap. Crude tall oil is used in various applications, such as adhesives, resins and inks. It also can be burned and used as a fuel.

Explanation of Provision

The provision modifies the cellulosic biofuel producer credit to exclude from the definition of cellulosic biofuel fuels with an acid number of greater than 25. The acid number is the amount of base required to neutralize the acid in the sample. The acid number is reported as weight of the base (typically potassium hydroxide) per weight of sample, or milligram ("mg") potassium hydroxide per gram. The normal acid number for crude tall oil is between 100 and 175. As a comparison, ASTM D6751 for biodiesel specifies that the acid number be less than 0.5mg potassium hydroxide. ASTM D4806 for ethanol does not have acid value but instead limits "acidity" to 0.007 mg of acetic acid per liter, which is significantly below an acid number of 25.

Effective Date

The provision is effective for fuels sold or used on or after January 1, 2010.

2. Source rules for income on guarantees (sec. 2122 of the bill and secs. 861, 862 and 864 of the Code)

Present Law

The United States taxes U.S. citizens and residents (including domestic corporations) on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations engaged in a trade or business in the United States on income that is effectively connected with the conduct of such trade or business (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with the conduct of a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S.

tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are connected with effectively connected income.[181] A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business.[182] In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.[183]

Subject to a number of exceptions, U.S.-source fixed or determinable, annual or periodical income ("FDAP") of a nonresident alien individual or foreign corporation that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. [184] Items of income within the scope of FDAP include, for example, interest, dividends, rents, royalties, salaries, and annuities. The tax generally is collected by means of withholding.[185]

Present law provides detailed rules for the determination of whether income is from U.S. sources or foreign sources. For example, the source of compensation for services is generally determined by the location in which the services were performed, regardless of the country of residence of the payor.[186] In contrast, the source of interest income is generally determined by reference to the country of residence of the obligor.[187] As a result, interest paid by a U.S. obligor typically is considered U.S.-source income, while interest paid by a foreign obligor is treated as foreign-source income. Rents and royalties paid for the use of property located in the United States are considered to be U.S.-source income.[188]

To the extent that the source of income is not specified in the statute, the Secretary may promulgate regulations that explain the appropriate treatment. Many items of income are not explicitly addressed by either the statute or the regulations. On several occasions, courts have

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[181] Secs. 864(c), 871(b), 873, 882(a) and 882(c).

[182] Sec. 884.

[183] Sec. 884(f).

[184] Secs. 871(a), 881(a).

[185] Secs. 1441 and 1442 provide for collection from nonresident aliens and foreign corporations, respectively.

[186] Under section 861(a)(3), compensation for personal services performed in the United States is U.S. source, unless the individual performing the services is a nonresident alien who is temporarily present in the United States, receives no more than $3,000 of compensation and is performing the services for a foreign person not engaged in a U.S. trade or business. Conversely, section 862(a)(3) provides that compensation for labor or services performed outside the United States is foreign source.

[187] Secs. 861(a)(1), 862(a)(1).

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

determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[189] As a result, items as dissimilar as alimony and letters of credit commissions were sourced by analogy to interest.[190] The U.S. Tax Court, in *Container Corp. v. Commissioner*, recently rejected IRS arguments that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were analogous to interest. The Tax Court held that the payments were more closely analogous to compensation for services, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.[191]

Explanation of Provision

This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner, supra,* by amending the source rules of section 861 and 862 to address income from guarantees issued after the date of enactment. Under new section 861(a)(9), income from sources within the United States includes amounts received, whether directly or indirectly, from a noncorporate resident or a domestic corporation for the provision of a guarantee of indebtedness of such person. The scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. A conforming amendment to section 862 provides that amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign source income if they are not from sources within the United States as determined under new section 861(a)(9).

For purposes of this provision, the phrase “noncorporate residents” has the same meaning as for purposes of section 861(a)(1), except that foreign partnerships are not included. Payments received from a foreign partnership for the provision of a guarantee of indebtedness of that foreign partnership are U.S. source if the amounts received are connected with income which is effectively connected with the conduct of a U.S. trade or business. A conforming amendment to section 864 provides that amounts received, whether directly or indirectly, for the provision of a

[189] *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[190] *Manning v. Commissioner*, 614 F.2d 815 (1st Cir. 1980); *Bank of America v. United States*, 230 Ct. Cl. 679, 680 F.2d 142 (1982), aff'g in part, rev'g in part, 47 AFTR 2d 81-652 (Ct. Cl. 1981).

[191] *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *gov't notice of appeal filed* (5th Cir. June 1, 2010).

guarantee are deemed to be effectively connected with the conduct of a U.S. trade or business if derived in the active conduct of a banking, financing or similar business.

Although this provision overturns the opinion in *Container Corp. v. Commissioner, supra,* no inference is intended with respect to the source of income received for the provision of a guarantee issued before the date of enactment. The Secretary may provide rules for determining the source of other types of payments that are not within the scope of this provision.

Effective Date

The provision applies to guarantees issued after the date of enactment. No inference is intended with respect to the source of income received with respect to guarantees issued before the date of enactment.

D. Time for Payment of Corporate Estimated Taxes (sec. 2131 of the bill and sec. 6655 of the Code)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.[192] For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15. In the case of a corporation with assets of at least $1 billion (determined as of the end of the preceding taxable year):

(i) payments due in July, August, or September, 2014, are increased to 174.25 percent of the payment otherwise due;[193]

(ii) payments due in July, August or September, 2015, are increased to 122.25 percent of the payment otherwise due;[194] and

(iii) payments due in July, August or September, 2019, are increased to 106.5 percent of the payment otherwise due.[195]

For each of the periods impacted, the next required payment is reduced accordingly.

Explanation of Provision

The provision increases the required payment of estimated tax otherwise due in July, August, or September, 2015, by 36 percentage points.

Effective Date

The provision is effective on the date of enactment of the bill.

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[192] Sec. 6655.

[193] Pub. L. No. 111-171; Pub L. No. 111-152; Pub. L. No. 111-147, Sec. 561, par. (1); Pub. L. No. 111-124, Sec. 4; Pub. L. No. 111-92, Sec. 18; Pub. L. No. 111-42, Sec. 202(b)(1).

[194] Pub. L. No. 111-171; Pub. L. No. 111-147, Sec. 561, par. (2).

[195] Pub. L. No. 111-147, Sec. 561, par. (3).