CCH Tax Briefing:

TREASURY RELEASES "GREEN BOOK" OF TAX PROPOSALS

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Special Report

HIGHLIGHTS:

- ✔ *Rate Hikes for Upper-Brackets*
- ✔ *Dividends Retain Favored Rates*
- ✔ *Expanded NOL Carrybacks Possible*
- ✔ *Tax-Free Gain on Small Business Stock*
- ✔ *Major International Tax Changes*
- ✔ *LIFO Repeal on the Table*
- ✔ *Increased Reporting Requirements*
- ✔ *Estate Tax Extension*

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Obama Administration Details Tax Plans; Middle Income Tax Cuts, International Reforms, Business Relief/Restrictions and More

The Obama administration released much-anticipated details about its proposed tax cuts and revenue raisers on May 11. The Treasury Department's *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (also known as the "Green Book") describes the administration's tax agenda, including permanent Making Work Pay, American Opportunity and research credits; a package of international tax reforms; reinstatement of the 36 and 39.6 percent individual marginal income tax rates; expanded information reporting; and automatic enrollment in IRAs. According to the Treasury, the proposals would generate $736.5 billion in savings for individuals (largely aimed at middle income taxpayers) and $71 billion in long-term savings for businesses. Revenue raisers would bring in roughly $900 billion.

Impact *The Green Book proposals represent a clear roadmap for Congressional action this year. With majorities in both the House and Senate, Democrats are likely to pass many, if not all, of the president's recommendations. However, some proposals may be scaled back or abandoned. For example, lawmakers are lukewarm to a permanent Making Work Pay credit. Many lawmakers have also distanced themselves from capping itemized deductions for high-income taxpayers. Some lawmakers also have expressed concerns about international tax reforms further harming the already fragile economy.*

INDIVIDUALS

The news for individuals is mixed. The administration wants to extend several temporary tax incentives targeted to middle income individuals. Higher income individuals would pay more in income taxes and capital gains taxes.

Making Work Pay Credit

The *American Recovery and Reinvestment Act of 2009 (2009 Recovery Act)* provides a refundable Making Work Pay tax credit of 6.2 percent of earned income, up to $400 for single taxpayers and up to $800 for married couples filing joint returns, for 2009 and 2010. The credit phases out for a single individual with modified adjusted gross income (AGI) between $75,000 and $95,000, and for married couples filing jointly with modified AGI between $150,000 and $190,000. The administration would make the credit permanent, reduce the phase-out rate from 2.0 to 1.6 percent and index the beginning of the phase-out range for inflation.

Impact *The Making Work Pay credit is technically claimed by taxpayers when they file their 2009*

(and 2010) returns. However, Congress wanted to accelerate the credit, so that it is delivered in small increments through reduced payroll withholding. Consequently, individuals with more than one job and pension recipients may experience under-withholding. Married taxpayers whose combined income places them in a higher tax bracket may also want to adjust their withholding.

Comment The $535 billion cost over 10 years of a permanent Making Work Pay credit would be paid for by revenues from proposed climate change (cap and trade) legislation.

Tax Rates

The *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)* lowered the individual marginal tax rates "temporarily" for a 10-year period. The current rates of 10, 15, 25, 28, 33, and 35 percent will sunset after 2010. The administration wants to extend the 10, 15, 25, and 28 percent rates for another 10 years, and reinstate the pre-*EGTRRA* top rates of 36 and 39.6 percent for individuals with incomes over $200,000 and married couples filing jointly with incomes over $250,000. Reinstating the 36 and 39.6 percent rates is estimated to raise $319.5 billion over 10 years.

Impact *Administration officials have been unclear if the $200,000/$250,000 amounts refer to adjusted gross income or taxable income. A Treasury official said that the 36 percent rate would start to apply to single taxpayers with taxable income above $200,000 minus the standard deduction and one personal exemption, indexed from 2009, and $250,000 minus the standard deduction and two personal exemptions, indexed from 2009, for married couples filing jointly. This same explanation has been applied to the proposed changes in capital gains and dividends tax rates. The administration also proposes to expand the 28 percent bracket to ensure that taxpayers earning less than these amounts would not experience a tax increase.*

Comment The current top rate of 35 percent starts at approximately $373,000 in taxable income for individuals and married couples filing jointly. The next highest rate, 33 percent, starts at approximately $172,000 in taxable income for individuals and roughly $209,000 in taxable income for married couples filing jointly.

"The Green Book proposals represent a clear roadmap for Congressional action this year."

Planning Tip. *The administration did not propose to accelerate the sunset of the EGTRRA rates, giving individuals until the start of 2011 to plan for the higher rates.*

Capital Gains

In 2003 and again in 2006, Congress lowered the maximum tax rates on qualified capital gains and dividends. For 2009, the maximum capital gains and dividends tax rate is 15 percent (zero percent for taxpayers in the 10 or 15 percent brackets). These lower rates are scheduled to sunset after 2010. The administration wants to impose a 20 percent rate on qualified capital gains and dividends for individuals who then fall within the new 36 or 39.6 percent brackets. The zero and 15 percent rates would be made permanent. Imposing the 20 percent tax rate on capital gains and dividends for higher-income taxpayers is projected to raise $117.9 billion over 10 years.

Impact *While the basic rate for net capital gains is going up for taxpayers in the two highest income tax brackets, the news is not all bad. The administration recommends continuing the favorable capital gains rates for qualified dividends in all income brackets. Before the change in 2003, dividend income was taxed at ordinary income tax rates and, unless legislation is enacted, that rate structure for dividends is scheduled to return in 2011.*

AMT Patch

The administration's FY 2010 budget assumes that Congress will continue to "patch" the alternative minimum tax (AMT) as it did for 2009. The 2009 patch provides higher exemption amounts. Additionally, the nonrefundable personal tax credits are allowed to the full extent of the taxpayer's regular tax and AMT liability.

Planning Note. *Congress is expected to continue to patch the AMT for the immediate future to prevent its encroachment on middle income taxpayers. Prospects for repeal of the AMT are dim as the tax raises huge amounts of revenue, which the government needs to offset projected deficits.*

Pease Limitation

EGTRRA repealed the limitation on itemized deductions for higher-income individuals (the "Pease" limitation, named after Rep. Donald Pease who sponsored the original legislation in Congress). For tax years beginning after December 31, 2009, the limitation on itemized deductions will no longer apply. The administration wants to reinstate the limitation on itemized deductions for individuals with incomes

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over $200,000 and married couples filing jointly with incomes over $250,000 (at 2009 levels) effective for tax years beginning after December 31, 2010.

Impact *Itemized deductions (excluding medical expenses, investment interest, theft and casualty losses, and gambling losses) would be reduced by three percent of the amount of adjusted gross income (AGI) that exceeds inflation-indexed statutory floors which are higher than under current law but not by more than 80 percent of the otherwise allowable deductions, the administration explained. For 2011, the AGI floors would be inflation-adjusted with a value of $200,000 in 2009 for individuals and $250,000 in 2009 for married couples filing jointly.*

Personal Exemption Phase-out (PEP)

EGTRRA repealed the personal exemption phase-out (PEP) for higher-income taxpayers. The personal exemption phase-out will no longer apply for tax years beginning after December 31, 2009. The administration wants to reinstate the personal exemption phase-out for individuals with incomes above $200,000 and married couples filing jointly with incomes over $250,000 (at 2009 levels) effective for tax years beginning after December 31, 2010.

Impact *The three percent Pease and PEP reductions would create a "bubble" tax rate on income within the phase-out ranges higher than the proposed 36 and 39.6 percent income tax rates.*

Itemized Deductions

Whenever itemized deductions would reduce taxable income in the 36 and 39.6 percent brackets (revived after 2010), the tax value of those deductions would be limited to 28 percent. The proposal would apply to itemized deductions (including mortgage interest and charitable deductions) after they have been reduced by the reinstating the pre-*EGTRRA* limitation on certain itemized deductions.

Impact *Under current law, the tax benefit of $10,000 paid in mortgage interest is $3,500 at the 35 percent bracket. The administration's proposal would limit the tax benefit to 28 percent ($2,800) for higher-income taxpayers after 2010.*

Comment A similar limitation would apply under the AMT.

American Opportunity Tax Credit

The *2009 Recovery Act* enhanced and renamed the HOPE education credit. The new credit – the American Opportunity Tax Credit – provides a maximum credit of $2,500 per student for 2009 and 2010 for qualified tuition and related expenses. Generally, 40 percent of the American Opportunity Tax Credit is refundable. The credit phases out ratably for individuals with modified AGI between $80,000 and $90,000 (between $160,000 and $180,000 for joint filers). The administration would make the American Opportunity Tax Credit permanent. Additionally, the expense amounts and phase-out limits would be indexed for inflation after 2010. A permanent American Opportunity Tax Credit would cost $48.5 billion over 10 years.

Impact *Unlike the HOPE credit, the American Opportunity Tax Credit is not limited to the first two-years of college. Course materials, such as books, are also eligible expenses.*

State and Local Sales Tax Deduction

Currently, individuals may take an itemized deduction for state and local general sales taxes instead of state and local income taxes. This deduction is temporary and will sunset after 2009. The administration would extend the state and local sales tax deduction through December 31, 2010.

Impact *The administration's proposals do not mention the temporary motor vehicle sales tax deduction for new vehicles purchased before December 1, 2009. That deduction may be taken either as an increased standard deduction or as an itemized deduction (but cannot be taken if already claimed as part of the state and local sales tax deduction).*

Tax Rate Schedules

Income Brackets	2009&2010	2011	Proposed 2011
Bottom	10%	15%	10%
Second	15%	15%	15%
Third	25%	28%	25%
Fourth	28%	31%	28%
Fifth	33%	36%	36%
Top	35%	39.6%	39.6%
Net Capital Gains			
10%/15% brackets	0%	10%	0%
Middle brackets	15%	20%	15%
Upper two brackets	15%	20%	20%

Child Tax Credit

The *2009 Recovery Act* enhanced the child tax credit by increasing the refundable portion of the credit for the 2009 and 2010 tax years to 15 percent of earned income in excess of $3,000. The administration would make the $3,000 threshold permanent for tax years beginning after December 31, 2010. The provision would cost $70.9 billion over 10 years.

Comment Families with three or more children may determine the credit under an alternative formula if this results in a larger credit. Under this formula, the credit equals the amount by which the taxpayer's Social Security taxes exceed the taxpayer's earned income credit.

EITC

The *2009 Recovery Act* expanded the earned income tax credit (EITC) for taxpayers with three or more qualifying children. The *2009 Recovery Act* also increased the phase-out range to provide marriage penalty relief. The administration would make these enhancements, which are scheduled to sunset after 2010, permanent. Marriage penalty relief would be indexed for inflation.

Comment The credit percentage under current law for families with three or more children is 45 percent with a maximum credit of $5,656.50.

Impact *The administration also proposed eliminating the advanced EITC, citing low usage by eligible taxpayers.*

RETIREMENT PLANNING

Automatic Enrollment in IRAs

Employers without a retirement plan would be required to offer automatic enrollment in an individual retirement account (IRA) to all employees on a payroll-deduction basis. Employees would be enrolled at a default rate of three percent. However, small employers (employers with fewer than 10 employees) would be exempt but are encouraged to participate. The proposal would be effective for tax years beginning after December 31, 2011.

Impact *The administration expects that payroll deductions will be directly deposited into IRA accounts. Additionally, the administration anticipates prescribing a low-cost, standard type of default investment and a limited number of low-cost investment alternatives.*

Impact *The proposal may be one of the administration's first salvos in reforming retirement savings options. Treasury officials have indicated that the administration is examining ways to strengthen 401(k)s and other defined contribution plans. One approach that has been raised in preliminary discussions is partially annuitizing 401(k)s.*

Planning Note. *To help defray some costs, employers would be eligible for a temporary tax credit of $25 per enrolled employee up to $250 each year for two years.*

Saver's Credit

Lower and middle-income individuals may currently be eligible to claim a nonrefundable credit for contributions to elective deferral plans or IRAs (the saver's credit). The maximum credit is $1,000. The administration proposes to make the saver's credit fully refundable. Additionally, the administration would convert the credit to a 50 percent match on up to $500 in qualified retirement savings. The amount of savings that would be matched would phase out at a rate of five percent of AGI in excess of $32,500 for individuals and $65,000 for married couples filing jointly.

Comment The $500 amount and the AGI amounts would be indexed annually for inflation for tax years beginning with the 2011 tax year.

BUSINESSES TAX INCENTIVES

The business tax incentives proposed by the administration are targeted tax cuts. Small businesses and businesses engaged in research activities would be the primary beneficiaries. There is also an open question as to what extent the administration would expand the extended net operating loss (NOL) carryback currently limited to small businesses.

Comment The GOP has unveiled some tax proposals aimed at a larger segment of the business population. They include an extension of bonus depreciation and increased small business expensing, and enhanced net operating loss (NOL) carryback. While Democrats in the House are unlikely to add any "sweeteners" to tax legislation to win GOP votes, Democrats in the Senate may be more accommodating, especially if tax legislation fails to move under the reconciliation process, which requires a simple majority in both chambers.

Net Operating Loss (NOL) Carryback

The *2009 Recovery Act* extended the two-year NOL carryback period for certain small businesses for applicable 2008 net operating losses (NOLs). Taxpayers may elect to carry back an applicable 2008 NOL three, four or five years. To qualify for the NOL carryback, a small business must have an average of $15 million or less in gross receipts over a three-year period ending with the year giving rise to the loss. The administration has signaled its support for "working with Congress to make a lengthened NOL carryback period available to more

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taxpayers." However, it has not specified the extent of the proposed expansion.

Impact *In previous years, Congress has extended the NOL carryback period without limiting the incentive to small businesses. It is unlikely that the current Congress will approve an extended NOL carryback for all taxpayers regardless of their size. It is more likely that lawmakers will increase the current $15 million gross receipts ceiling, and do so for 2009 and then wait to see if it is also needed in 2010. The Green Book's revenue allocations anticipate NOL tax relief of $27.8 billion in 2009 and $35.7 billion in 2010, far above the $4.7 billion in NOL relief provided under the 2009 Recovery Act.*

Qualified Small Business Stock

The *2009 Recovery Act* expanded a special tax break to help small C corporations raise capital by allowing non-corporate investors who purchase original issue stock to cut the tax on their profit. If a five-year holding period is met, qualifying individuals can exclude 75 percent of their gains on qualified small business stock from taxable income. The 75 percent exclusion is available for stock acquired after February 17, 2009, and before January 1, 2011.

The administration would raise the exclusion to 100 percent for qualified stock issued after February 17, 2009. This treatment would cost $5.8 billion over 10 years.

Impact *The 75 percent exclusion resulted in an effective regular tax rate of 7 percent and 12.88 percent under the AMT. The 100 percent exclusion would result in an effective tax rate of zero percent. This tax break also becomes more valuable to higher-income taxpayers who should expect to have their capital gains tax rate increase to 20 percent after 2010.*

Comment As in the past, the new exclusion would apply only to the extent that the gain does not exceed the greater of (1) 10 times the taxpayer's adjusted basis in the stock disposed of during the tax year, or (2) $10 million, reduced by gain excluded in earlier years from sales of stock in the corporation.

Research Tax Credit

The *Emergency Economic Stabilization Act of 2009 (EESA)* extended the research tax credit for qualifying research activities, including wages, to amounts paid or incurred in 2008 and 2009. The *EESA* also increased the alternative simplified research credit to 14 percent for 2009. The administration would make the research credit, which is currently a temporary incentive, permanent.

Impact *A permanent research tax credit would cost $74.4 billion over 10 years. That significant price tag has been the reason for prior temporary extensions. The two compelling reason for making the credit the credit permanent are (1) the need for the U.S. to stay competitive in the global race for market share and (2) the reality that research often requires long-term funding for which the credit is a make-or-break offset for many companies.*

Comment The *EESA* also eliminated the election to use the alternative incremental method of calculating the research credit (effective for tax years beginning after December 31, 2008). It is unclear if the administration would revive the alternative incremental method or make permanent the credit as it is in 2009.

EXTENDERS

Every year, Congress debates whether to extend a package of temporary but popular tax incentives. The administration has signaled its support to extend these temporary incentives through December 31, 2010. At this time, it is unclear if the administration supports extending all of the extenders or only the ones that it has specifically identified in the Green Book and other FY 2010 budget documents.

Comment Most Congressional leaders consider an extension of some of the expiring provisions, together with the expiring AMT patch and estate tax, essential tax legislation that must be passed by year end 2009.

Administration-Identified Extenders

The administration has specifically identified some extenders for extension

Timeline For Major Tax Changes

Changes:	Year:
Individuals Tax Cut Extensions:	2011
Rate Increase for Higher Brackets	2011
NOL Carryback Expansion:	2009 – 2010
Permanent R&D Credit:	2010
LIFO Repeal	2012
International Tax Changes	2011
Small business stock	2009
Estate Tax Extension	2010

through December 31, 2010. They are:

- ***Subpart F active financing*** (income derived from the active conduct of banking, finance, insurance or similar business is temporarily excluded from subpart F income);
- ***Tax treatment of certain payments to controlling exempt organizations*** (excludes these payments from unrelated business income);
- ***New Markets Tax Credit*** (allows a credit for making qualified equity investments in designated Community Development Entities (CDEs));
- ***Qualified leasehold improvements*** (improvements eligible for a 15-year Modified Adjusted Cost Recovery System (MACRS) recovery period);
- ***Qualified restaurant improvements*** (eligible for a 15-year MACRS recovery period);
- ***Empowerment and community renewal zones*** (eligible for special tax incentives, such as tax-exempt financing initiatives); and
- ***Credits for biodiesel and renewable diesel fuels*** (includes a variety of tax incentives are available to encourage the production of biodiesel and renewable diesel fuels).

More Extenders

A number of other extenders will also expire at the end of 2009. Although the administration did not specifically identify these extenders for extension, their exclusion from the Green Book should not be interpreted as reducing their chances of passing. They include:

- ***Teacher's classroom expense*** deduction of up to $250 annually;
- ***Higher education deduction*** for post-secondary education, with income phase-outs;
- ***Tax-free charitable distributions from IRAs*** for individuals age 70 1/2 and older for distributions up to $100,000 (in lieu of a charitable deduction);
- ***Temporary suspension of required minimum distributions*** for retirement plans beyond the current 2009 tax year moratorium;
- ***Indian employment credit*** against a portion of qualified wages and health insurance costs for qualified employees who work on an Indian reservation;
- ***Enhanced charitable deduction for contributions of computer technology*** and equipment by C corporations;
- ***Enhanced charitable deduction for contributions of food*** by a business (including a *2009 Recovery Act* enhancement for farmers and ranchers);
- ***Enhanced charitable deduction for contributions of books*** to public schools by C corporations;
- ***District of Columbia first-time homebuyer's credit***; and
- ***Deduction option for Brownfields remediation.***

Planning Note. *Less certain is the fate of some recent temporary tax incentives, such as the first-time homebuyer credit, the deduction for state and local sales and use taxes paid on the purchase of new motor vehicles, temporary premium assistance for COBRA continuation coverage, the $2,400 exclusion for unemployment benefits received in 2009, and the additional standard deduction for real property taxes for non-itemizers. These incentives are relatively new and, with the exception of the first-time homebuyer credit and the additional standard deduction for real property taxes for non-itemizers, have not been extended before.*

INTERNATIONAL TAX CHANGES

The administration would make sweeping reforms to the international tax rules. Four of the ten Green Book proposals on international tax reform were previewed earlier in May by the White House. These four measures, which would generate almost $210 billion in revenue, are:

- Mandatory deferral of deductions (except research and development expenses) associated with foreign-source income not currently subject to U.S. tax;
- Computation of the deemed foreign tax credit based on the amount of the consolidated earnings and profits of all foreign subsidiaries repatriated to the U.S. taxpayer;
- Matching that would prevent the separation of creditable foreign taxes from the associated foreign income in the case of hybrid arrangements; and
- Required check-the-box election of corporation status for certain overseas "disregarded entities" established by U.S. businesses (with first-tier foreign eligible entities excepted).

Impact *Critics fear that the international tax proposals will make U.S.-based multinational companies less competitive in the global marketplace, especially during tough economic times. The administration sees these provisions constructively in terms of loophole closers and as a method of keeping jobs in the U.S. Neither camp, however, will see results immediately: the provisions are not proposed to be effective until tax years beginning after December 31, 2010.*

Impact *The administration did not propose complete repeal of the deferral system, which generally allows a U.S. based company to defer U.S. taxation on its foreign-source income until the earnings are repatriated. Instead, the proposals are more tailored and are designed to limit the ability of a U.S. taxpayer to take deductions for offshore expenses against U.S. income. The administration has not yet addressed the mechanics of how to calculate the amount of deferred deductions to match foreign expenses with deferred income.*

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Impact *Changing the check-the-box rules will impact almost every multi-national entity. The administration did not indicate if check-the-box reform will include a grandfathering provision.*

Other International "Loophole Closers"

The Green Book also introduces six new international tax reform measures to the administration's overall assault on the present international tax regime. Although these additional measures, raising $11.6 billion, are dwarfec by the changes already on the table, they likely will be no less controversial. These "international loophole closers" would:

- Limit the ability of U.S. multinationals to shift income outside the U.S. through intangible property transfers;
- Limit current earnings-stripping practices by expatriated entities by tightening the availability of an interest deduction paid by an expatriated entity to related persons;
- Repeal the boot-within-gain cap now available for earnings and profits of foreign subsidiaries in cross-border reorganizations;
- Repeal the 80/20 company rules that effectively treats as foreign-source income certain dividends and interest paid by a domestic corporation if at least 80 percent of its gross income over three years is foreign source;
- Revamp the withholding rules on dividends to prevent avoidance by foreign portfolio investors through equity swaps; and
- Modify the foreign tax credit rules for dual capacity taxpayers to allow foreign levies to be a creditable tax only if the foreign country generally imposes an income tax.

LIFO REPEAL

To partially pay for the individual and business tax incentives, the administration would repeal the last-in, first-out (LIFO) method of accounting for inventories. Under the proposal, taxpayers would track the cost of goods sold using the costs of the earliest acquired or manufactured inventory items. Taxpayers would recognize income stemming from any built-up LIFO reserves on a pro-rata basis over the course of eight tax years, beginning with the first tax year after December 31, 2011. The administration projects that repeal of LIFO would generate $65 billion in revenue over 10 years.

Impact *The impact of LIFO repeal may be less monumental today than previously as the U.S. moves to adoption of International Financial Reporting Standards (IFRS) for publicly-traded corporations. IFRS does not allow the LIFO method of inventory accounting because it creates disparities between book and tax basis for the same inventory.*

Impact *LIFO repeal would not only impact oil and gas companies (which are most often cited by the administration) but also many "main street" businesses, such as retailers and automobile dealers. When inventory costs are rising (when inflation is high), using the LIFO method will generally mean less tax liability than under the first-in, first-out (FIFO) method. If prices fall, LIFO taxpayers repay the LIFO benefit through greater tax liability. Some critics of this proposal argue that this downside risk is sufficiently real, especially in the current economy, and that LIFO should not be labeled a tax loophole.*

Comment The administration observes that LIFO is a "tax deferral opportunity," allowing taxpayers whose inventory costs increase over time to continuously reduce their taxable income by netting taxable revenues against ever-increasing costs of goods sold.

Comment Observers have commented that repeal of LIFO inventory accounting could also assist Congressional efforts to broaden the corporate tax base, a stated perquisite to eventually lowering the current 35 percent tax rate on corporate income.

Lower-of-Cost-or-Market for Inventory

The administration would also repeal the lower-of-cost-or-market adjustments to inventory allowed for taxpayers who do not use the LIFO method of accounting. The proposed change would prohibit companies from writing down the taxable value of inventories to reflect a drop in market price, damage, imperfection, or other similar causes.

Comment Taxpayers would be required to recognize the increased

Major Revenue Raisers (2010-2019)

Upper Bracket Rate Increases	$615.4 billion
International Tax Changes	$209.8 billion
LIFO Repeal	$ 61.1 billion
Carried Interest	$ 23.5 billion
Information Reporting	$ 10.5 billion

income resulting from this accounting method adjustment over the course of four tax years, effective 12 months after its date of enactment.

Impact *The administration has called the lower-of-cost-or-market accounting regime a "one-way mark-to-market regime" and violation of the realization principle; meaning that taxpayers must recognize all increases in wealth as taxable income. While companies are allowed to decrease the value of their inventory when its market value decreases, they are not required to increase its value when its replacement cost increases.*

Comment Under the administration's proposal, taxpayers would still be allowed to use the retail inventory method for tax purposes if they also use that method for financial accounting.

OTHER REVENUE RAISERS

In addition to the increase in individual tax rates for higher-income individuals, international tax measures, and LIFO/accounting method reform, the administration is proposing a host of other ways to raise revenue. These proposals are generally aimed at stopping tax abuses and increasing transparency; but they also target oil and gas preferences in a bid to indirectly encourage green energy.

Codification of Economic Substance Doctrine

Some tax avoidance transactions can literally satisfy the requirements of the Internal Revenue Code while contradicting its spirit. The courts have developed the "economic substance doctrine" to trump any literally correct but abusive technique. The administration proposes codification of the economic substance doctrine. It also recommends a 30 percent penalty for violation of this new statutory provision, as well as the denial of any interest deduction connected with any related understatement of tax.

Impact *One side of the argument believes the economic substance doctrine is needed as a Code provision to prevent uneven application among the courts. Others have voiced concern over having a rigid statutory doctrine through which loopholes would develop. Codification of the economic substance doctrine has appeared as a revenue raising provision in several pieces of legislation proposed in 2008. With "revenue raisers" even more of a valuable commodity this year, the $4.7 billion revenue boost assigned to this provision by the administration makes its passage more likely than ever.*

Carried Interest

Made particularly notorious by hedge fund managers, carried interest --partnership profits interests allocable to the performance of services-- have been taxed as capital gains and not ordinary income subject to self-employment tax. Under an administration proposal, a services partnership interest (SPI) would be taxed as ordinary income, regardless of the character of the income at the partnership level.

Comment The proposal defines an SPI as a carried interest held by a person who provides services to the partnership. There is a carve-out for reasonable allocations for invested capital. Loans or advances, however, would not count as invested capital for this purpose.

Crackdown on Offshore Tax Avoidance

The administration's concern over the use of offshore bank and other financial accounts by certain U.S. individuals and businesses to evade U.S. taxes has culminated in a series of measures to strengthen the information reporting and withholding systems. The administration's proposals largely involve enhancing withholding and reporting by Qualified Intermediaries (QIs), areas it has already been aggressively pursuing using existing laws.

To crackdown on offshore tax avoidance, the administration proposes, among other things, to:

- Require QIs to report all reportable payments received on behalf of U.S. account holders;
- Mandate a 30 percent withholding rate on payments of U.S.-source fixed or determinable annual or periodical (FDAP) income made through nonqualified intermediaries;
- Require a 20 percent withholding rate on gross proceeds paid to certain nonqualified intermediaries;
- Require individual income tax reporting of certain transfers of money or property made to or from certain foreign financial accounts;
- Require foreign bank and financial account (FBAR accounts) to be disclosed with individual income tax returns; and
- Double to 40 percent the accuracy-related penalties on understatements of income involving undisclosed foreign accounts.

Increased Reporting

The administration views transparency, through the ability of the IRS to obtain more information, as a growing part of a successful assault against the tax gap, the difference between what taxpayers should be paying and what the IRS collects. The Green Book proposes to increase information reporting by businesses, contractors, insurance companies, and government entities. The enhanced reporting requirements would:

- Impose information reporting on businesses that make payments to corporations of $600 or more in a calendar year and withholding for contractors without certified Taxpayer Identification Numbers (TINs);

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- Require contractors to provide certified TINs to businesses from which they receive payments of $600 or more in a calendar year;
- Enhance reporting by life insurance companies in order to crack down on tax avoidance through the use of private separate life insurance accounts; and
- Authorize the Treasury and the IRS to require information reporting on all non-wage payments made by federal, state and local governments to acquire property or services.

In addition, to put teeth into both these new information reporting requirements and existing ones, the administration proposes to double the penalties for unintentional failures to file information returns and increasing related annual maximum penalties.

Compliance and Enforcement

The administration proposes to improve business compliance through mandatory e-filing requirements and enhanced penalties.

E-filing. The administration proposes requiring electronic filing (e-filing) by all corporations and partnerships that file a Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More). Corporations that do not comply with e-filing requirements would face a $25,000 penalty ($5,000 for tax-exempts). Return preparers would also be required to e-file individual, estate and trust returns if they file more than 100 returns per year (or other persons who file more than 250 returns).

Offers-in-compromise. Not all of the administration's compliance proposals are necessarily tougher on taxpayers. Take, for example, the proposal to eliminate from the IRS's Offer-In-Compromise (OIC) program the requirement that taxpayers include a nonrefundable payment with their initial offer.

Comment This would increase access to the OIC program for many taxpayers previously shut out from the program due to their inability to afford the lump-sum payment.

Enforcement. To provide incentive for taxpayers to comply with the tax law, the administration proposes to make certain repeated, willful failures to file a tax return a felony, and to allow the IRS to treat court-ordered criminal restitution payments as tax debt so that collection is easier.

Comment The administration would also extend the statute of limitations where a state tax adjustment affects a federal tax liability. The administration would also extend the penalty for bad checks to electronic checks and other forms of payments, as well as strictly prohibit any deduction for punitive damages.

Corporate stock transactions. The Green Book also lists several corporate stock techniques that the administration believes need to be reigned in. The administration would require that:

- A corporate using a forward contract to issue stock must treat a portion of the payment on issuance as interest;
- Dealers in commodity derivates, securities and equity options must treat income from day-to-day activities as ordinary, not capital; and
- Expand the definition of control for the Sec. 249 deduction on the repurchase of debt instruments to include indirect control relationships.

ESTATE AND GIFT TAX

Change to the estate tax is "must-do" legislation for 2009. Under *EGTRRA*, the estate tax is repealed for 2010 but then returns at higher-pre-2001 levels in 2011. This present-law result is untenable, according to most Capitol Hill observers. The administration's Green Book offers a temporary solution to the estate tax rate structure, while also making some tweaks to stop some developing abuses.

Extend 2009 estate/gift tax levels. The administration's proposals assume as a baseline the continuation of estate and generation skipping-transfer taxes at their present 2009 levels. Under current law they are scheduled to be entirely repealed in 2010 and then revert to higher pre-2001 rates and lower exemptions starting in 2011. The $3.5 million estate tax exclusion and maximum 45 percent rate would continue into 2010.

Impact *Extending the estate tax at its present level for 2010 will raise revenue over and above having no estate tax as scheduled. Extending it beyond 2010 at its present level, however, would cost revenues over and above pre-2001 levels. As a result, many observers predict passage this year of only a one-year extension into 2010, with those revenues used to offset an extenders package. Meanwhile, estate planners must continue using multiple alternative will clauses to cover whatever level of estate tax may be imposed in the future.*

Estate and gift valuations. Among one of the larger of the administration's proposed domestic revenue raisers is the

requirement to consistently value estates and gifts. The basis of inherited property that a taxpayer receives by reason of a decedent's death under Code Sec. 1014 must be equal to the value of that property for estate tax purposes.

Basis. Additionally, the basis of property received as a gift during the life of the donor must also equal the donor's basis. In effect, these proposals require that the basis of property in the hands of the recipient are no greater than the value of the property as determined for purposes of the estate or gift tax.

Comment Estate executors would also have new reporting requirements.

In order to restrict techniques used by taxpayers to discount the value of inherited property, the administration proposes to create a new category of restrictions called "disregarded restrictions" under Code Sec. 2704(b). This new provision would affect estates and trusts.

GRAT terms. The administration would also impose 10-year minimum terms for grantor retained annuity trusts (GRATs). It reasons that there should be some greater downside risk in the use of the GRAT technique to minimize gift tax costs.

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