

# American Jobs and Closing Tax Loopholes Act (H.R. 4213)

June 17, 2010

Special Report

## HIGHLIGHTS

- Individual/Business Incentives
- Energy Extenders
- Infrastructure Incentives
- National Disaster Relief
- Pension Funding Relief
- International Tax Reforms
- Change in Taxation of Carried Interest
- S Corp Taxation
- And More

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## Senate Democrats Streamline Extenders Bill; Prune Revenue Raisers

The Senate’s Democratic leadership unveiled a streamlined version of the “American Jobs and Closing Tax Loopholes Act” (H.R. 4213) on June 16 hoping to secure bipartisan support. The revised Senate bill modifies two controversial revenue raisers: a change in the taxation of carried interest and the imposition of self-employment tax on S corps. The revised Senate bill keeps a package of tax extenders, many temporary individual, business, energy, charitable and infrastructure tax incentives which expired at the end of 2009. The Senate bill retains a package of pension funding reforms and makes some minor changes to international tax reforms. The revised Senate bill includes Code Sec. 6707A penalty relief and a taxpayer-friendly modification to the first-time homebuyer credit.

**IMPACT.** Democratic leaders in Congress are keen to portray the tax extenders bill as a “jobs” bill, reflecting their emphasis on job creation in 2010 after passage of the Hiring Incentives to Restore Employment (HIRE) Act earlier this year. However, fiscal conservatives in both chambers remain troubled by the bill’s price tag.

**COMMENT.** While the core group of one-year extensions of individual and business tax benefits has virtually no opposition in either the House or the Senate, the sticking point remains how they will be paid for. Opponents argue that the revenue raisers under consideration are permanent tax increases for temporary incentives.

**COMMENT.** If Senate Democrats can secure 60 votes to pass their revised bill, the bill will go back to the House or to confer-

*ence. Democratic leaders in both chambers are aiming to send a final bill to President Obama before Independence Day.*

### INDIVIDUAL EXTENDERS

The House and Senate bills provide one-year extensions to a handful of individual tax incentives that expired after December 31, 2009. The extensions are retroactive to January 1, 2010 and apply to calendar year 2010. A Senate amendment would also extend until September 30, 2010, the Homebuyer Tax Credit’s current June 30, 2010 deadline for closing on pre-May 1, 2010 sales contracts.

**COMMENT.** Certain extenders affecting individuals are also covered in this Tax Briefing under “Charitable Provisions,” “Energy Extenders,” and “National Disaster Relief.”

### Homebuyer Tax Credit

A Senate amendment to the House bill would extend the deadline for closing home purchases in order to qualify for the first-time homebuyer credit. Under the Senate amendment, taxpayers with a binding contract executed before May 1, 2010, would now have until September 30, 2010, to close on their residence and qualify for the first-time homebuyer credit.

**COMMENT.** A credit of up to \$8,000 for first-time homebuyers (\$6,500 for long-time homeowners) generally had been available to qualified taxpayers on homes purchased before May 1, 2010. Under a binding contract rule, however, the

credit remained available if the taxpayer entered into a binding written contract before May 1, 2010, and closed on the purchase of a principal residence before July 1, 2010.

**IMPACT.** Many prospective homeowners who anticipated that there would be more than enough time to close title on a purchase before July 1st have found that banks have needed more time to complete transactions such as short sales in today's financial markets. The Senate amendment, however, does not extend the May 1, 2010 contract date.

### Additional Standard Deduction for Real Property Taxes

Prior to January 1, 2010, individuals who did not itemize their deductions could claim an additional standard deduction for all or part of their qualified state and local real property taxes, up to \$500. For married couples filing a joint return, the maximum deduction was \$1,000. The additional standard deduction for state and local real property taxes expired after December 31, 2009. The House and Senate bills extend this additional standard deduction through December 31, 2010.

**IMPACT.** The \$500/\$1,000 deduction does not lower the taxpayer's adjusted gross income (AGI). This amount is added to the standard deduction.

**IMPACT.** Taxpayers who have paid or are close to paying off their home mortgages or who otherwise have few itemized deductions may benefit from the additional standard deduction for real property taxes.

### State and Local Sales Tax Deduction

The American Jobs Creation Act of 2004 and subsequent legislation allowed taxpayers the option of taking an itemized deduction for either: (1) state and local income taxes or (2) state and local general sales

taxes. The state and local sales tax deduction expired after December 31, 2009. The House and Senate bills extend this election through December 31, 2010.

**PLANNING NOTE.** Taxpayers can calculate their state and local sales tax deduction either by saving receipts or using the *Optional State Sales Tax Tables* provided by the IRS. Taxpayers residing in states with no income tax are likely to benefit from this election.

**COMMENT.** Taxpayers are free to deduct state and local income taxes in one tax year and state and local general sales taxes in another tax year.

### Higher Education Tuition Deduction

Before January 1, 2010, qualified taxpayers could take an above-the-line deduction for qualified higher education tuition and related expenses. The maximum deduction of \$4,000 went to qualified taxpayers with adjusted gross income (AGI) not exceeding \$65,000 (\$130,000 for joint filers). A reduced deduction of up to \$2,000 was available to qualified taxpayers with AGI up to \$80,000 (\$160,000 for joint filers). The higher education tuition deduction expired after December 31, 2009. The House and Senate bills extend the incentive through December 31, 2010.

**COMMENT.** Elementary and secondary education expenses are not deductible.

**COMMENT.** The House and Senate bills clarify that the deduction is unavailable to a taxpayer for whom a credit for higher education under Code Sec. 25A (the HOPE and Lifetime Learning Credits) would have provided a greater net reduction in tax liability, without regard to any disallowance or reduction in the credit's value as a result of the alternative minimum tax (AMT).

**CAUTION.** If an education expense is deductible under any other provision, such

as the American Opportunity Tax Credit (AOTC) or Lifetime Learning Credit, a taxpayer cannot claim a double tax benefit.

### Teacher's Classroom Expense Deduction

Teachers, principals, guidance counselors, and other education professionals working in kindergarten through twelfth grade were able to deduct qualified out-of-pocket classroom expenses before January 1, 2010. The deduction was above-the-line with a \$250 maximum. Eligible expenses included the costs of supplies, equipment, books, and software used in the classroom. The teacher's classroom expense deduction expired after December 31, 2009. The House and Senate bills extend the incentive through December 31, 2010.

**PLANNING NOTE.** The teacher's classroom expense deduction has a \$250 annual ceiling. If a qualified taxpayer itemizes deductions, the taxpayer may be able to deduct classroom expenses that exceed the \$250 cap as an employment-related miscellaneous itemized deduction subject to the two-percent floor.

## BUSINESS EXTENDERS

The House and Senate bills also extend many temporary business tax incentives, which expired after December 31, 2009, through tax years ending on December 31, 2010. The Senate bill also provides for Code Sec. 6707A penalty relief.

### Code Sec. 6707A Penalty Relief

The Senate bill makes the Code Sec. 6707A penalty for failing to disclose reportable transactions proportionate to the tax benefit received. The maximum penalty for individuals would be \$100,000 and \$200,000 for all other taxpayers. The minimum penalty would be \$5,000 for individuals and \$10,000 for all other taxpayers.

**COMMENT.** The House approved similar Code Sec. 6707A relief in the Small Busi-

*ness Jobs Tax Relief Act of 2010 (H.R. 5486) on June 15.*

### Research Tax Credit

Code Sec. 41 provides a tax credit for qualified research and experimentation (R&E) expenditures. The research tax credit expired after December 31, 2009. The House and Senate bills extend the research credit for one year, for amounts paid or incurred through December 31, 2010.

**IMPACT.** *Taxpayers and Congress agree that a permanent research tax credit would better jump-start the long-term investments needed to maximize research funding. However, the revenue cost of a permanent credit is prohibitive to the overall extenders bill. The one-year R&E extension is by far the most expensive in the pending legislation costing over \$6 billion.*

### Refundable AMT Credits

The House and Senate bills allow business taxpayers to elect to apply 10 percent of unused AMT credits toward qualified investments in domestic manufacturing facilities and equipment in 2010.

### Differential Pay Credit

Qualified small businesses could take a 20-percent tax credit for differential wages up to \$20,000 paid to qualified employees who are called to active military duty. The differential wage payment credit, which initially applied to amounts paid after June 17, 2008, expired after December 31, 2009. The House and Senate bills extend the incentive through December 31, 2010.

**COMMENT.** *A qualified small business for purposes of the differential wage payment credit is a business with fewer than 50 employees.*

### Qualified Leasehold Improvements

In the American Jobs Creation Act of 2004, Congress authorized a 15-year recovery pe-

riod under the Modified Accelerated Cost Recovery System (MACRS) for qualified leasehold improvement property placed in service after October 22, 2004 and before January 1, 2006, using the straight-line method and the half-year convention unless the mid-quarter convention applies. Subsequent legislation extended this treatment to apply to qualified leasehold improvement property placed in service before January 1, 2010. The House and Senate bills extend this treatment to apply to qualified leasehold improvement property placed in service before January 1, 2011.

“The revised Senate bill modifies two controversial revenue raisers: a change in the taxation of carried interest and the imposition of self-employment taxes on S corps.”

**IMPACT.** *Unless this measure is extended, a leasehold improvement placed in service in 2010 will be depreciated over 39 years using the straight-line method beginning in the month the improvement was placed in service.*

### Qualified Restaurant Property

Congress created a new category of 15-year property under MACRS called “qualified restaurant property” in the American Jobs Creation Act of 2004. Subsequent legislation extended the 15-year MACRS recovery period for qualified restaurant improvement property placed in service before January 1, 2010. The House and Senate bills extend the 15-year MACRS recovery period for qualified restaurant improvement property placed in service before January 1, 2011.

### Retail Improvement Property

Qualified retail improvement property placed in service in 2009 was treated as

MACRS 15-year property. This temporary measure expired after December 31, 2009. The House and Senate bills extend the 15-year MACRS recovery period for qualified retail improvement property that is placed in service before January 1, 2011.

**COMMENT.** *Congress provided for a new category of MACRS, qualified retail improvement property, to extend the benefits provided for qualified leasehold improvements to retail properties that are owner-occupied.*

### Indian Employment Credit

The Indian Employment Credit provides a credit to employers of qualified employees who work and live on or near an Indian reservation. The credit is 20 percent of the excess of current wages and health insurance costs paid to qualified employees over the amounts paid in 1993. The total amount of qualified wages and employee health insurance costs (except any amount paid or incurred for health insurance under a salary reduction arrangement) used to calculate the credit cannot exceed \$20,000 per employee per tax year. The Indian Employment Credit expired after December 31, 2009. The House and Senate bills extend the Indian Employment credit for wages paid or incurred through December 31, 2010.

**COMMENT.** *The House and Senate bills also extend accelerated depreciation for qualified Indian reservation property.*

**COMMENT.** *The qualified employee for purposes of the Indian Employment Credit must be an enrolled member of a Native American tribe or the spouse of an enrolled member of a Native American tribe. Additionally, the qualified employee must perform substantially all of his or her services for the employer within an Indian reservation, and have his or her main home on or near that reservation.*

### Film and Television Production Costs

For productions commenced before January 1, 2010, qualified taxpayers could elect to deduct the first \$15 million of qualified film

and television production costs in the year the expense is incurred in lieu of capitalizing the costs through depreciation allowances. This treatment expired after December 31, 2009. The House and Senate bills extend the incentive through December 31, 2010.

### **Environmental Remediation**

Before January 1, 2010, businesses could elect to treat qualified environment/brownfields remediation expenditures as deductible in the year paid or incurred. The House and Senate bills extend expensing of environment/brownfields remediation costs to expenses incurred before January 1, 2011. Additionally, the House and Senate bills extend the exclusion of gain or loss on the sale or exchange of certain brownfield sites from unrelated business taxable income.

### **Regulated Investment Companies**

Several temporary provisions applying to regulated investment companies (mutual funds) and their shareholders expired after December 31, 2009. The provisions included measures with respect to interest-related dividends and short-term capital gains dividends of mutual funds; the look-through of certain mutual fund stock for purposes of determining the gross estate of nonresidents who are not U.S. citizens; and the treatment of a mutual fund investing in real estate as a qualified investment entity with respect to dispositions of investments in U.S. real property. The House and Senate bills extend these measures through December 31, 2010.

### **Active Financing Income/Look-Through**

Generally, U.S. shareholders of a controlled foreign corporation (CFC) are subject to tax on certain income earned by the CFC even if the income is not currently distributed. Past legislation has provided exceptions from Subpart F. These include “active financing” exceptions for certain income derived in the active conduct of a banking, financial, insurance, or similar business.

Past legislation has also provided for look-through exceptions for certain dividends, interest, rents, and royalties received by one CFC from a related CFC. These measures expired after December 31, 2009. The House and Senate bills extend the exceptions for active financing and the look-through exceptions through December 31, 2010.

### **More Extenders**

The House and Senate bills would also extend through December 31, 2010, the following business provisions:

- Five-year write-off of farm machinery/equipment;
- Mine rescue training credit;
- Election to expense mine safety equipment;
- Railroad track maintenance credit;
- Real estate investment trust (REIT) timber treatment;
- Seven-year motorsports entertainment cost recovery;
- Tax incentives for empowerment zones;
- Tax incentives for investment within the District of Columbia;
- Renewal community tax incentives;
- Modification of tax treatment of certain payments to controlling exempt organizations;
- Code Sec. 199 domestic production activities deduction for qualified activities in Puerto Rico;
- Temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the U.S. Virgin Islands; and
- American Samoa Economic Development Credit.

*COMMENT. The House and Senate bills also allow taxpayers to claim the mine rescue training credit and bonus depreciation allowance against AMT.*

## **CHARITABLE EXTENDERS**

The House and Senate bills extend a number of tax incentives to encourage contributions to charitable organizations by individuals and businesses.

### **IRA Contributions to Charity**

Before January 1, 2010, individuals age 70 1/2 or above could distribute up to \$100,000 from their IRAs to a charitable organization without recognizing income and without having to take an itemized charitable deduction that ordinarily carries specific contribution-based limitations. The House and Senate bills extend the provision for qualified charitable distributions from IRAs through December 31, 2010.

*IMPACT. The measure does not apply to ongoing SEP or SIMPLE IRAs, or to inherited IRAs if the beneficiary reached age 70 1/2 before the distribution.*

### **Conservation Contributions of Real Property**

The Heartland, Habitat, Harvest, and Horticulture Act of 2008 extended special rules for contributions of real property for conservation purposes, originally enacted in the Pension Protection Act of 2006, through December 31, 2009. Under those provisions, an individual donor could take a deduction for a qualified conservation contribution to a Code Sec. 170(b)(1)(A) eligible organization to the extent that the aggregate of such contributions does not exceed 50 percent of the donor's contribution base over the amount of all other charitable contributions allowable under Code Sec. 170(b)(1). Excess amounts could be carried over for up to 15 years. The House and Senate bills extend these special rules for contributions of real property for conservation purposes to contributions made through December 31, 2010.

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

## Contributions of Food Inventory

The enhanced deduction for charitable contributions of food inventory expired after December 31, 2009. The House and Senate bills extend the enhanced deduction for charitable contributions of food inventory through December 31, 2010.

**COMMENT.** *Donations of food must consist of “apparently wholesome food,” which is food intended for human consumption that meets all quality and labeling standards imposed by federal state and local laws and regulations, even though the food may not be marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.*

## Contributions of Book Inventory to Public Schools

The deduction for qualified book contributions by qualified corporations to public schools expired after December 31, 2009. The House and Senate bills extend the deduction for qualified book contributions by C corporations to public schools made during tax years beginning on or before December 31, 2010.

**CAUTION.** *S corporations cannot take this special deduction for qualified book contributions to a public school.*

**COMMENT.** *A qualified book contribution is a charitable contribution of books to a public school providing elementary or secondary education with a regular faculty and a regularly enrolled student body.*

## Contributions of Computer Inventory

Contributions of computer technology and equipment by a corporation for educational purposes may qualify for a special deduction equal to the corporate donor's basis in the donated property plus one-half of the ordinary income that would have been realized if the property had been sold. This spe-

cial treatment expired after December 31, 2009. The House and Senate bills extend the enhanced deduction for contributions of computer technology and equipment by a corporation for educational purposes through December 31, 2010.

## S Corps' Charitable Contributions

For tax years beginning after 2005 and before 2010, a shareholder's basis in the stock of an S corporation making a charitable contribution was reduced by the shareholder's pro rata share of the adjusted basis of the contributed property, rather than the less favorable pro rata share of the fair market value of the contributed property. The House and Senate bills extend this basis adjustment treatment through December 31, 2010.

## Controlling Exempt Organizations

The House and Senate bills extend through December 31, 2010 special rules for interest, rents, royalties, and annuities received by an exempt entity from a controlled entity.

## ENERGY EXTENDERS

The House and Senate bills extend several temporary energy tax incentives.

**COMMENT.** *Members of Congress have attributed the failure to renew certain energy tax incentives earlier this year with causing job layoffs, especially in the energy production sector.*

## Alternative Motor Vehicle Credit for Heavy Hybrids

Hybrid vehicles that use gasoline and electricity may qualify for an alternative motor vehicle credit. Separate credits are available for automobiles and light trucks; and medium and heavy trucks. The credit, available generally since 2006, ends after 2009, 2010 or 2014, depending on the type of vehicle. The House and Senate bills extend these end dates, respectively, for one year.

## Credits for Biodiesel and Renewable Diesel Fuel

The Tax Code provides for a biodiesel credit, a biodiesel small producer credit and a biodiesel excise credit, which expired at the end of 2009. The House and Senate bills extend the income tax credit, excise tax credit and payment provisions for biodiesel and renewable diesel through December 31, 2010.

## Credits for Natural Gas/Liquefied Petroleum Gas Used as Transportation Fuel

The House and Senate bills extend the alternative fuel production credit and payment provisions for compressed and liquefied natural gas and liquefied petroleum gas through December 31, 2010.

## Sales of Electric Transmission Property

Vertically integrated electric utilities can defer gain up to eight years when they sell qualified electric transmission property to qualified independent transmission companies and subsequently reinvest the proceeds in certain natural gas or electricity production. The House and Senate bills extend the deferral provision to sales before January 1, 2011.

## More Energy Incentives

- Modify the standards for energy-efficient windows, doors and skylights eligible for the Code Sec. 25C residential energy property credit;
- Extend the new energy efficient home credit for eligible contractors and producers of manufactured homes;
- Extend the placed-in-service date for the steel industry fuel tax credit;
- Extend the placed-in-service date for eligibility for a tax credit for the production of coke or coke gas;
- Extend suspension of the limitation on percentage depletion for oil and gas from marginal wells;

- Extend the credit for electricity produced at qualified open-loop biomass facilities; and
- Provide tax-free direct payments in lieu of tax credits to manufacturers of qualified energy efficient appliances at 85 percent of the Code Sec. 45M tax credit.

**IMPACT.** *The House and Senate bills modify the Code Sec. 25C residential energy property credit but do not extend the credit. In 2009 and 2010, an individual may claim a credit (up to \$1,500) for 30 percent of the cost of installing energy-efficient exterior windows, doors and skylights; energy-efficient heating and air conditioning systems, insulation, water heaters (natural gas, propane or oil); roofs (metal and asphalt); and biomass stoves. The House and Senate bills also modify the credit by linking eligibility for the tax credit to the Energy Star requirements.*

**COMMENT.** *Oil and gas tax preferences are especially vulnerable after the Gulf oil spill and the Obama administration's commitment to reducing the nation's dependence on fossil fuels. Repeal of oil and gas preferences could fund an extension of COBRA premium assistance or the first-time homebuyer credit.*

## INFRASTRUCTURE INCENTIVES

The House and Senate bills extend and modify a number of temporary infrastructure incentives.

### Bonds

The House and Senate bills include a variety of enhancements to the Build America Bonds program. The bills would exclude water and sewage exempt-facility bonds from the state volume caps and bond financing facilities for water and sewage facilities from limitations on tribal government issuances. Additionally, the bills exclude certain categories of private activity bonds from the alternative minimum tax (AMT) if issued in 2011 and to refunding of private activity bonds issued after 2003 and refunded during 2011. The bills also extend and make an additional allocation of Recovery Zone bonds.

**COMMENT:** *The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) included similar provisions applicable to private activity bonds issued in 2009 or 2010 and to refunding of private activity bonds issued after 2003 and refunded during 2009 and 2010.*

### New Markets Tax Credit

The New markets Tax Credit program grants a 39-percent total federal tax credit over the course of seven years to taxpayers who make qualifying investments in a community development entity. The House and Senate bills allow the New Markets Tax Credit to be claimed against the alternative minimum tax (AMT) with respect to qualified investments made on or after March 15, 2010 and on or before December 31, 2010.

**IMPACT:** *The American Recovery and Reinvestment Act of 2009 allocated a maximum of \$5 billion for the credit for 2008 and 2009. Low Income Housing Credit*

The American Recovery and Reinvestment Act of 2009 allowed state housing credit agencies to directly receive a payment for low-income housing in lieu of low-income housing credit allocations for 2009. The House and Senate bills extend this treatment for allocations for 2010.

### Federal Home Loan Banks

The House and Senate bills extend tax-exempt eligibility for loans guaranteed by Federal Home Loan Banks.

### Small Issuer Rules

The House and Senate bills extend temporary small issuer rules for allocation of tax-exempt interest expense. These rules would now sunset on December 31, 2011.

## NATIONAL DISASTER RELIEF

Traditionally, disaster relief has been enacted on a disaster-by-disaster basis. In 2008, Congress passed the National Disaster Relief Act

(2008 Disaster Relief Act). The 2008 Disaster Relief Act provided a variety of temporary provisions to assist taxpayers nationwide recovering from a qualified disaster. The House and Senate bills extend the national disaster relief provisions through December 31, 2010.

**COMMENT.** *A federally declared disaster is a disaster occurring in an area that is determined by the President to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.*

### Losses Attributable to Federal Disasters

Prior to January 1, 2010, the 10 percent of AGI limitation applicable to personal casualty loss deductions was waived for personal "net disaster losses." A net disaster loss is the excess of the personal casualty losses occurring in a disaster area and attributable to a federally declared disaster after 2007 and before 2010, over personal casualty gains. The House and Senate bills extend this treatment through December 31, 2010.

**CAUTION.** *One provision in the pending legislation "disaster assistance" section is not pro-taxpayer. The 2008 Disaster Relief Act increased the amount by which all individuals claiming casualty losses must reduce their personal casualty losses from each casualty event from \$100 to \$500 for tax years beginning after December 31, 2008 and ending before January 1, 2010. Under current law, the reduction is \$100 for tax years beginning after December 31, 2009. The House and Senate bills extend the \$500 deductible for each casualty loss through December 31, 2010.*

**COMMENT.** *A taxpayer may elect to deduct a casualty loss in a federally-declared disaster area on his or her return for the immediately preceding tax year to accelerate the benefit.*

### Special Depreciation Allowance for Disaster Property

The 2008 National Disaster Act provides an additional 50-percent bonus depreciation

deduction on property that rehabilitates or replaces qualified business property damaged by a federally declared disaster. This treatment expired after December 31, 2009. The House and Senate bills extend the measure for property placed in service in a qualified disaster area before January 1, 2011.

### NOLs Attributable to Disasters

The 2008 National Disaster Act provides a five-year net operating loss (NOL) carryback for qualified federally-declared disaster losses. The five-year NOL carryback for qualified disaster losses expired after December 31, 2009. The House and Senate bills extend the five-year NOL carryback for qualified disaster losses through December 31, 2010.

**PLANNING NOTE.** *Taxpayers can elect to disregard the five-year carryback rule for their qualified disaster loss. The normal two-year carryback period would then apply.*

### Current Deduction of Disaster Expenses

The 2008 National Disaster Act allows qualified businesses to currently deduct rather than capitalize qualified disaster clean-up and repair expenses. Generally, these expenses are related to the clean up or repair of property from damage caused by a federally declared disaster. This treatment expired after December 31, 2009. The House and Senate bills extend this treatment through December 31, 2010.

**COMMENT.** *Qualified disaster expenses for purposes of the enhanced deduction are expenses paid or incurred in connection with a trade or business or business-related property that otherwise must be capitalized and that are for (1) the abatement or control of hazardous substances that were released on account of a federally declared disaster; (2) debris removal or demolition of structures on real property damaged or destroyed by a federally declared disaster; or (3) repair of business-related property damaged by a federally declared disaster.*

### Qualified Mortgage Bonds

The 2008 National Disaster Act waives certain mortgage revenue bond requirements where an affected taxpayer's principal residence is destroyed or damaged as a result of a federally-declared disaster. The House and Senate bills extend this provision through December 31, 2010.

**COMMENT.** *The Senate bill, but not the House bill, modifies disaster Low-Income Housing Tax Credits (LIHTC).*

### PENSION FUNDING RELIEF

Since passage of the Pension Protection Act of 2006 (PPA), some pension plans have struggled to remain healthy, especially during the economic slowdown. The House and Senate bills include several pension funding relief measures for both single employer and multi-employer plans.

**IMPACT.** *While couched in terms of "relief," several of the pension funding provisions raise significant revenue. The single-employer plan provisions could raise \$1.3 billion over 10 years; the multiemployer provisions*

*would raise \$800 million over 10 years principally because smaller required contributions would mean lower deductions.*

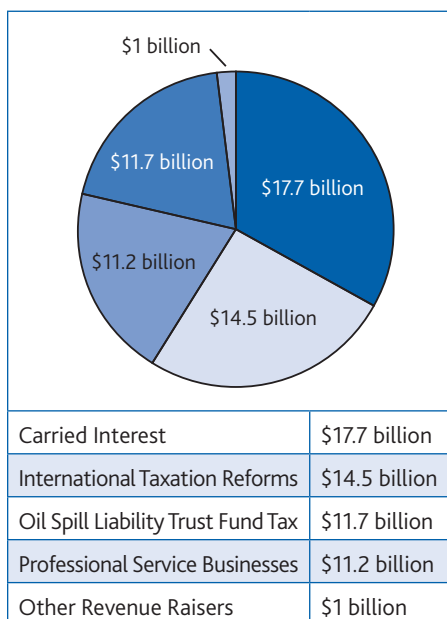
**IMPACT.** *The funding relief provisions do not waive or alter an employer's obligation to fully fund its pension plan but do offer a troubled employer additional time to meet its pension funding obligations.*

### Single Employer Plans

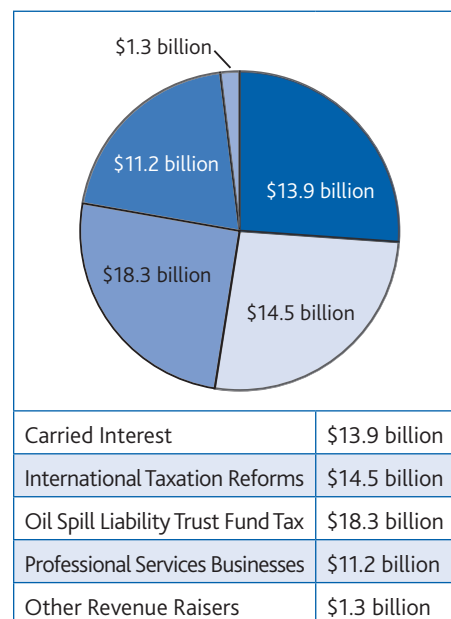
**Eased funding rules.** Defined benefit plans are subject to minimum funding rules that require the employer to make annual contributions to fund plan benefits. If a single-employer plan is underfunded, the plan has a funding shortfall that must be amortized in level installments over seven years, beginning with the current plan year.

Under the House and Senate bills, a sponsor of a single-employer defined-benefit plan may elect to amortize the shortfall under two alternative extended amortization schedules – a nine-year period (two plus seven) or a 15-year period – that begin with the election year. The nine-year period requires the payment of interest only in the first two years, followed by level installments in the

### HOUSE REVENUE RAISERS OVER 10 YEARS



### SENATE REVENUE RAISERS OVER 10 YEARS



remaining seven years. Level annual installments would be required for the 15-year period. The installments must be increased if an employer pays excess compensation, extraordinary dividends or redeems stock. Plan sponsors may elect relief for up to two plan years during the four-plan-year period from 2008-2011.

**Plans subject to prior funding rules.** The PPA's funding rules were delayed for multi-employer plans of certain cooperatives, PBGC settlement plans, and single-employer plans of government contractors. The House and Senate bills offer two types of funding relief to underfunded plans with delayed PPA effective dates. A plan can elect either reduced additional funding requirements or a 15-year amortization period.

*COMMENT. The pending legislation also delays the PPA effective date and provides special interest rate rules for eligible national charities and their local chapters. The charity provisions apply to plan years beginning after December 31, 2007.*

**Lookback for benefit restrictions.** The PPA limits benefit payments and accruals for plans whose adjusted funding target attainment percentage (AFTAP) is less than 60 percent. The Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) provided relief for plan years beginning during the period October 1, 2008 through September 30, 2009 by substituting the plan's AFTAP from the plan's preceding plan year. The House and Senate bills extend the WRERA relief to plan years beginning through 2011. The relief allows a plan to apply its AFTAP for the last plan year beginning before September 30, 2009.

**Minimum contributions.** A plan may apply a prior year's credit balance (amounts exceeding minimum contributions) to a later year's required minimum contributions, unless the plan is less than 80 percent funded. Under the House and Senate bills, for the period 2009 to 2011, a single-employer defined benefit plan may offset its minimum required contributions by a credit balance if the plan was at least 80 percent funded.

The House and Senate bills permit the payment of benefits as a Social Security leveling payment, which otherwise would be prohibited, for 2010 and 2011. The bills also temporarily permit employers to contribute shutdown benefits without having to waive pre-funding credit balances.

**PBGC reporting.** The House and Senate bills require a plan sponsor to provide fee information to the PBGC if the sponsor's plan has unfunded vested benefits exceeding \$75 million. Under current law, additional reporting is required if the plan's funding percentage is below 80 percent.

**Airline bankruptcy.** The House and Senate bills permit airline employees to roll over bankruptcy settlement amounts to a traditional IRA (in addition to Roth IRAs) and to recharacterize a prior settlement contribution to a Roth IRA as a contribution to a traditional IRA.

### Multiemployer Plans

A multiemployer plan is a plan to which more than one employer must contribute and which is maintained under a collective bargaining agreement. Multiemployer plans must amortize net experience losses over 15 years. The House and Senate bills allow plans to elect a 30-year period for certain losses incurred in either of the first two plan years ending on or after June 30, 2008. The bills also extend the maximum smoothing period for determining plan asset values from five years to 10 years for the first two plan years ending on or after June 30, 2008.

**Endangered or critical status.** The PPA imposes additional funding requirements on multiemployer plans that are in "endangered or critical status." Plans must adopt a 10-year funding improvement plan or a rehabilitation plan. WRERA provided an additional three-year period for these plans. The House and Senate bills permit a five-year extension, or two additional years for a plan that elected WRERA relief. If the collective bargaining parties cannot agree on a contribution schedule, the bills

would allow plan trustees to elect a schedule approved for at least 75 percent of the employees participating in the plan. The provision will not apply to plan years beginning after 2014.

**Amortization waivers.** Plans that have received amortization waivers under pre-PPA law may treat the return on plan assets for plan years including any of the period June 30-October 31, 2008 as the interest rate used for charges and credits to the plan's funding standard account.

**Certification.** The House and Senate bills provide transition rules for certifications of a plan's funded status.

*COMMENT. The House bill includes a package of defined contribution fee disclosure rules for plan years beginning after December 31, 2011, with a reasonable good faith interpretation of the provision allowed until 12 months after final regulations are issued. The Senate bill does not include similar disclosure rules.*

## COBRA PREMIUM ASSISTANCE

COBRA allows qualified individuals to extend employer-provided group health coverage, if they would otherwise lose the coverage due to certain events such as loss of a job. The COBRA premium may be higher than individual's premium while employed, but is generally lower than that for private, individual health insurance coverage. The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) and subsequent legislation temporarily reduced the premium for COBRA or comparable state continuation coverage (mini-COBRA) for assistance eligible individuals.

Generally, an assistance eligible individual is an employee or a member of the employee's family who elects COBRA coverage timely following a qualifying event related to an involuntary termination of employment occurring between September 1, 2008 through May 31, 2010. Assistance eligible individu-



als pay 35 percent of their COBRA premium costs and are treated as paying the full amount. Employers are reimbursed for their 65 percent portion of the premium payment through a payroll tax credit.

**COMMENT.** *A provision to extend COBRA premium assistance through November 30, 2010 was dropped from the final House bill at the eleventh hour due to cost concerns. The revised Senate bill also does not include an extension of COBRA premium assistance.*

## INTERNATIONAL TAX REFORMS

The House and Senate extenders bills include a number of international tax reform measures. Some of the measures reflect proposals by the Obama administration; others build on measures previously introduced in Congress.

**COMMENT.** *The pending legislation does not include a controversial international entity-classification reform proposed by the Obama administration in its fiscal year (FY) 2010 federal budget. The White House had called for repeal of the “check-the-box” rules. The administration dropped this recommendation in its FY 2011 federal budget.*

### Foreign Tax Credit Reforms

The Obama administration is concerned about abuses involving the foreign tax credit, which is designed to prevent double taxation of foreign income. Corporations have devised techniques that keep the foreign income untaxed in the U.S., while foreign taxes are used to offset U.S. tax due on other foreign-source income. Often the foreign source income is permanently reinvested offshore and never taxed in the U.S.

The House and Senate bills adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. The bill would suspend the recognition of foreign tax credits until the related foreign income is taxed in the U.S.

**IMPACT.** *These foreign tax credit reforms would prevent inappropriate separation of creditable foreign taxes in cases such as hybrid arrangements.*

**IMPACT.** *The rules to prevent splitting foreign tax credits from the income to which they relate will apply to foreign income taxes paid or accrued after May 20, 2010 and to foreign income taxes paid or accrued by a foreign corporation on or before May 20, 2010 and not deemed paid under Code Sec. 902(a) or 960.*

**Asset acquisitions.** If a stock acquisition is treated as an asset acquisition, the assets acquired obtain a stepped-up basis. For a foreign entity, this step-up exists only for U.S. taxes, not foreign taxes. The House and Senate bills prevent taxpayers from claiming the foreign tax credit on foreign income that is never taxed in the U.S. under this scenario.

**Treaties and interest expense.** The foreign tax credit is limited to the maximum U.S. tax rate (35 percent) on foreign-source income. According to the Obama administration, taxpayers are using treaties to inflate foreign-source income by shifting the source of certain assets (for example, U.S. securities) to foreign branches and disregarded entities. The House and Senate bills segregate the income so that it is not used for claiming foreign tax credits. The bill would also ensure that foreign-source interest expense is taken into account when determining the foreign tax credit limitation.

**Section 956.** Code Sec. 956 recharacterizes income from the sale of property as a dividend. The House and Senate bills would limit the foreign tax credits claimed on a deemed dividend under Code Sec. 956 to the amount that would have been allowed on an actual dividend.

### Redemptions

If a foreign parent company owns a U.S. company, which in turn owns a foreign subsidiary, the latter's earnings are taxed in the U.S. when distributed to the U.S. shareholder. If the foreign parent sells stock in the U.S. company to its foreign subsidiary, the

## What's Next for Tax Legislation

The Extenders Act represents the third piece of major tax legislation to clear Congress in 2010. The Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147) and the Health Care Reform Package (P.L. 111-148 and P.L. 111-152) have already made hundreds of changes to the Internal Revenue Code. Nevertheless, Congress is not finished, with a “must-do” tax list left for 2010 that includes:

- Addressing the levels at which income tax rates should be set for 2011 and beyond, with higher rates anticipated for upper bracket taxpayers;
- Reinstating the federal estate tax, at levels yet to be determined; and
- Extending an alternative minimum tax (AMT) patch for 2010 to protect middle-income taxpayers.

parent can recharacterize the gain as a dividend, which allows the foreign subsidiary's earnings to bypass U.S. taxes. The House and Senate bills require the subsidiary's earnings to remain subject to U.S. tax when repatriated to the foreign parent as a dividend.

### 80/20 Rules

Dividends and interest paid by a U.S. corporation to a foreign payee may be excluded from U.S. withholding tax if at least 80 percent of the U.S. corporation's gross income is foreign-source during a three-year test period and is attributable to the active conduct of a foreign trade or business. The House and Senate bills would repeal the 80/20 company rules and also repeal the 80/20 rules for interest paid by resident alien individuals effective for tax years beginning after December 31, 2010. The Senate bill would also eliminate the withholding and foreign tax credit benefits for 80/20 companies prospectively, subject to a “grandfather” rule.

### Source Rules on Guarantees

Under the House and Senate bills, guarantees would be sourced like interest and if

paid by U.S. taxpayers to foreign persons generally would be subject to withholding tax. This treatment would be effective for guarantees issued after the date of enactment. The Senate bill further clarifies that the provision applies only to guarantees of indebtedness rather than to guarantees of obligations.

*COMMENT. This provision reverses the Tax Court's ruling in Container Corp., 134 T.C. No. 5, CCH Dec. 58,131, which treated guarantee fees as services.*

### HIRE Act Disclosures

The Hiring Incentives to Restore Employment (HIRE) Act included a package of foreign account compliance rules. The House and Senate bills clarify when the limitations period will be tolled for corporations failing to provide requisite information on cross-border transactions or foreign assets. If failure to provide the required information is due to reasonable cause and not willful neglect, the limitations period would not be tolled.

## CARRIED INTEREST REVENUE RAISER

A partnership does not pay income tax. Rather, income or loss flows through to the partners who include these items on their individual income tax returns. Certain partners may receive an interest in future profits in exchange for services, which is known as a "carried interest." Under current law, this income is generally taxed at capital gains rates. Both the House and Senate bills change the taxation of carried interest but take different approaches.

**House bill.** The House bill generally treats net income from an investment services partnership as ordinary income to the extent it is attributable to a partner's qualified capital interest. A portion of recharacterized income is taxed at ordinary income tax rates. For tax years beginning before January 1, 2013, the amount of recharacterized income taxed at ordinary rates would be 50

percent. The percentage rises to 75 percent for tax years beginning after December 31, 2012. The carried interest provision in the House bill is effective for tax years ending on or after January 1, 2011.

*IMPACT. The House bill does not exempt any industries, such as commercial real estate, from the change in taxation of carried interest. Venture capital firms in particular have been lobbying hard for some carve outs. While the House bill itself represents a compromise in light of opposition to the sweeping effect of the carried interest provision, further fine tuning may take place before a new "extenders' law is finally sent to President Obama.*

**Senate bill.** Under the Senate bill, carried interest would be taxed capital gain tax rates to the extent that carried interest reflects a return on invested capital. To the extent that carried interest does not reflect a return on invested capital, 75 percent of the remaining carried interest would be treated as ordinary income beginning on January 1, 2011. The amount treated as ordinary income would be reduced to 50 percent for carried interest that does not reflect a return on invested capital but which is attributable to the sale of assets which are held for five or more years.

*COMMENT. The Senate bill also provides that the lower percentage applies to the gain or loss attributable to the underlying assets held for five or more years when a partnership interest is sold as well as to gain attributable to Code Sec. 197 intangibles of a partnership whose principal activity is providing specific investment management services with respect to the assets of the partnership when the partnership interest has been held for five or more years. On selling an interest in any publicly traded partnership, a person who is not an investment service provider would be exempt from the rule that recharacterizes as ordinary income under Code Sec. 751(a) that portion of the gain or loss attributable to an investment services partnership interest.*

*IMPACT. Managers of investment companies generally are paid in the neigh-*

*borhood of two percent of fund assets as an annual management fee. Additionally, they may receive 20 percent of the profits above certain levels. Under current law, this 20 percent carried interest is taxed at a lower 15 percent capital gains rate rather than at ordinary income tax rates.*

*COMMENT. Under current law, the top individual marginal income tax rate of 35 percent is scheduled to rise to 39.6 percent after December 31, 2010. The maximum capital gain tax rate of 15 percent is also scheduled to rise to 20 percent starting in 2011.*

*IMPACT. Some investment companies have warned that the change will preclude them from offering attractive incentive opportunities for key personnel.*

*COMMENT. The ordinary income would be subject to self-employment tax.*

*COMMENT. Securities include stock, debt, derivatives, a hedge on securities, and other financial instruments.*

## S CORPS AND EMPLOYMENT TAXES

The House and Senate bills target what some lawmakers view as employment tax evasion by certain service professionals who route their earnings through an S corp, limited partnership, or other entity while claiming a nominal salary.

**House bill.** The House bill would impose self-employment payroll taxes on S corp. passthrough income in two situations: (1) where an S corp. is engaged in a professional service business and its principal asset is the reputation and skill of three or fewer employees or (2) where the S corp. is a partner in a professional service business. Professional service sector S corps include activities such as health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

**Senate bill.** The Senate bill tracks the House bill but with some modification. In the case where an S corp. is engaged in a professional service business and its principal asset is the reputation and skill of three or fewer employees, the Senate provision would apply only if 80 percent or more of the professional service income of the corporation is attributable to the services of three or fewer owners of the corporation.

***IMPACT.** Like all employers, S corps must withhold and pay over federal income tax and FICA taxes on wages. However, S corps can pay both wages and make distributions to shareholders, but only wages are subject to employment taxes. The IRS has discovered some shareholders taking nominal wages and the bulk of their earnings as distributions.*

***COMMENT.** According to the General Accounting Office (GAO), S corps with the fewest shareholders comprise the largest portion of shareholder compensation net underpayments. The GAO also has told Congress that the IRS has pursued tax evasion charges in only the most egregious cases when shareholders are paid little or no wages.*

***COMMENT.** The S corp. provision has generated concern among many tax professionals. Several practitioner associations have cautioned that the provision is unenforceable and is contrary to decades of IRS practice. They have also said that the IRS has sufficient enforcement tools on hand to prevent abuse by a small minority of businesses.*

## OTHER REVENUE RAISERS

### Dividends Received in Reorganization Exchanges

A limitation on recognition of gain for certain qualified corporate reorganizations can result in distributions of property with minimal U.S. tax consequences, according to the Obama administration. The House and Senate bills repeal this limitation in reorganization transactions in which the acquiring corporation is either domestic or foreign and the shareholder's exchange has the effect of the distribution of a dividend within the meaning of Code Sec. 356(a)(2).

***COMMENT.** The House and Senate bills clarify that the Secretary of the Treasury has the flexibility of adding to the types of reorganizations in which earnings and profits of the parties to the reorganization are taken into account in determining dividend treatment.*

### Reverse Morris Trust Transactions

The House and Senate bills target abuses in so-called "Reverse Morris Trust" transactions. Under a Reverse Morris Trust, a parent company spins-off a subsidiary, which merges into an unrelated company tax-free when the shareholders of the parent company control more than 50 percent of the voting rights and economic capital of the resulting merged company.

***IMPACT.** The Reverse Morris Trust has been criticized as providing a tax loophole for companies wanting to sell unwanted assets.*

### Oil Spill Liability Trust Fund

The House bill would raise the federal oil spill liability trust fund excise tax to 34 cents per barrel through December 31, 2020. The Senate bill increases the federal oil spill recovery trust fund excise tax to 41 cents per barrel through December 31, 2020.

### Corporate Estimated Tax

The House bill increases corporate estimated tax payments for large corporations due in July, August and September 2015 by 36 percentage points.

### Punitive Damages

The Senate bill, but not the House bill, denies a tax deduction or payments made for punitive damages in connection with any legal judgment or settlement. If a taxpayer's punitive damages are paid by an insurer, the Senate bill provides that the amounts paid on behalf of the taxpayer are included in the taxpayer's gross income.

***COMMENT.** The Senate provision would apply to damages paid or incurred after December 31, 2011.*

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