



## FY 2011 FEDERAL BUDGET —TAX PROPOSALS

### Special Report

#### HIGHLIGHTS:

- ✓ *Extended Making Work Pay Credit*
- ✓ *2010 Bonus Depreciation/Expensing*
- ✓ *Higher Child Care Credit*
- ✓ *Reinstatement of Top Tax Rates*
- ✓ *Tax-Free Small Business Stock*
- ✓ *\$5,000 Employee Hiring Credit*
- ✓ *Sweeping International Tax Reforms*
- ✓ *Enhanced Information Reporting*
- ✓ *Reinstated Estate Tax*

## Obama Unveils \$3.83 Trillion Budget; Tax Proposals Focus On Job Creation, Revenue

President Obama presented Congress with his fiscal year (FY) 2011 federal budget proposals on February 1, and the \$3.83 trillion budget emphasizes job creation and deficit reduction. Tax incentives for individuals and businesses total approximately \$300 billion with an additional \$100 billion allocated to job creation. On the other hand, proposed tax increases would raise \$1.4 trillion. Although rate increases for higher-income taxpayers would bring in the lion's share of that revenue, the budget calls for over \$450 billion in other revenue raisers. Those increases impact many categories of taxpayers but, perhaps most directly, those with international operations.

*Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) income tax rate cuts, the already expired estate tax, and a long list of other must-pass "expiring provisions"—including an alternative minimum tax (AMT) patch—that will all need retroactive treatment.*

**Comment** Some of the president's tax proposals have already gained momentum on Capitol Hill. The Senate may vote on the jobs creation component of the president's FY 2011 budget before mid-February. Senate Democrats are drafting a jobs bill, which is expected to include a credit for small businesses that hire new employees, along with an extension of bonus depreciation and enhanced Code Sec. 179 expensing.

**Impact** *While many of the president's FY 2011 tax proposals previously appeared in his FY 2010 budget, notable differences are apparent not only in scope but also in details. Also different from last year is that many of the president's proposals are likely to be enacted this year. The administration must show that it can get something done on the legislative front. With job creation front-and-center on the national stage, success in passing high-profile tax legislation this year is a likely priority for the president and the Democratic-controlled Congress. More tax legislation this year is guaranteed by the expiring Economic*

### INDIVIDUALS – TAX BREAKS

#### Making Work Pay Credit

The Making Work Pay Credit (MWPC) provides a refundable tax credit of up to \$400 for individuals and up to \$800 for married taxpayers filing joint returns. The MWPC, as approved under the American Recovery and Reinvestment Act of 2009 (2009 Recovery Act), applies to the 2009 and 2010 tax years. The president proposes to extend the MWPC for one year, through December 31, 2011.

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The MWPC is primarily delivered through reduced withholding. The MWPC is calculated at a rate of 6.2 percent of earned income. Income phase-outs apply. The MWPC phases out at a rate of two percent of modified adjusted gross income (AGI) in excess of \$75,000 for single individuals and it phases out at a rate of two percent of modified AGI in excess of \$150,000 for married couples filing a joint return.

**Impact** *In his FY 2010 budget proposal, the president endorsed a permanent MWPC. The federal budget deficit, however, has made a permanent MWPC an unrealistic goal.*

### Economic Recovery Payments

In 2009, qualified seniors, disabled individuals and veterans, recipients of Railroad Retirement Board (RRB) benefits, and Supplemental Security Income (SSI) recipients received one-time payments of \$250. The president wants to make another round of “one-time” payments of \$250 to these qualified individuals in 2010.

**Impact** *Any MWPC for which an individual might be eligible is reduced by the amount of any economic recovery payment. According to the IRS, early filing trends indicate that some working taxpayers who received economic recovery payments in 2009 and a MWPC are not properly reporting the \$250 payment on their returns.*

### Refundable Credit for Federal/State Workers

Individuals who retired from federal, state, and local government employment may not be eligible for Social Security benefits. Consequently, they would not receive a one-time \$250 economic recovery payment under the president’s FY 2011 budget proposal. The president asked Congress to provide federal, state, and local government retirees with a \$250 refundable tax credit when they file their 2010 federal income tax returns in 2011.

**Comment** The 2009 Recovery Act provided a similar one-time \$250 tax credit for federal, state and local government retirees in 2009, which eligible individuals claim when they file their 2009 returns in 2010.

**“Tax incentives for individuals and businesses total approximately \$300 billion with an additional \$100 billion allocated to job creation.”**

### COBRA Premium Assistance

The 2009 Recovery Act provided a nine month subsidy to help individuals involuntarily terminated from employment to continue their health insurance coverage under COBRA. Assistance eligible individuals pay 35 percent of their COBRA premiums and are treated as paying the full amount. The FY 2010 Defense Appropriations Act extended eligibility for COBRA premium assistance through February 28, 2010, and provided for a total of 15 months of assistance. The president proposes to extend eligibility for the COBRA subsidy through December 31, 2010. The duration of the assistance period for qualified individuals who are involuntarily terminated from employment after February 28, 2010 would be 12 months.

**Comment** Under current law, involuntary termination from employment must occur between September 1, 2008 and February 28, 2010 and the individual must be eligible for COBRA coverage at any time during that period. The House has already approved legislation extending the eligibility period through June 30, 2010.

**Impact** *The president did not recommend making any changes to how employers are reimbursed for their 65 percent of COBRA premium assistance. Employers are reimbursed through a credit on Form 941, Employer’s Quarterly Federal Tax Return.*

**Comment** Higher income individuals may waive COBRA premium assistance. If they do not, they may be subject to recapture rules. Individuals with modified AGI between \$125,000 and \$145,000 (\$250,000 and \$290,000 married couples filing jointly) must repay a portion of the subsidy. If a taxpayer’s modified AGI exceeds \$145,000 (\$290,000 for married couples filing jointly), the full amount of the subsidy must be repaid as an additional tax. These income levels would not be revised under the president’s proposed extension.

### EITC

The 2009 Recovery Act enhanced the earned income tax credit (EITC) by increasing the credit percentage for families with three or more children to 45 percent. This treatment, however, is only available for 2009 and 2010. The president proposes to make permanent the 45 percent credit for families with three or more children.

**Comment** The president also proposes to eliminate the advanced EITC.

### Child and Dependent Care Credit

Taxpayers who incur expenses to care for a child under age 13 or for an incapacitated dependent or spouse in order to work or look for work can claim a credit ranging from 20 percent to 35 percent of employment-related expenses, based on AGI. The maximum eligible expenses are \$3,000 for taxpayers with one qualifying individual and \$6,000 for taxpayers with two or more qualifying individuals.

The president proposes increasing the AGI level at which the 35 percent credit begins to phase out to 20 percent dramatically, from \$15,000 to \$85,000. The 20 percent credit, therefore, would be applied to taxpayers with AGI in excess of \$113,000 (rather than above the \$43,000 level now in place). The permanently enhanced credit would be available for tax years beginning after December 31, 2010.

**Impact** *Under the president's proposal, therefore, taxpayers with incomes up to \$85,000 would be entitled to a maximum \$1,050 credit (\$2,100 for more than one qualifying individual). For those with more than \$113,000 AGI, a maximum \$600 (\$1,200) credit would apply. Under current law, however, the dollar limits on the expenses eligible for the credit are reduced by the amount of any employer-provided dependent care benefits excluded from the taxpayer's income. The president proposes no changes to this treatment.*

**Comment** The child care credit should not be confused with the child credit. The child credit, which is now \$1,000, is scheduled to revert to \$500 after 2010. The president's baseline assumptions in his FY2011 budget proposals include retaining the \$1,000 maximum credit, as well as its refundability.

### American Opportunity Tax Credit

The 2009 Recovery Act expanded and renamed the Hope education credit as the American Opportunity Tax Credit (AOTC) for 2009 and 2010. Eligible taxpayers receive a tax credit based on 100 percent of the first \$2,000 of tuition, fees and course materials paid during the tax year, plus 25 percent of the next \$2,000 of tuition, fees and course materials paid during the tax year. The AOTC may be claimed for expenses for the first four years

of post-secondary education. The president proposes to make the AOTC permanent.

The credit is reduced ratably if a single individual's modified AGI exceeds \$80,000 and a married couple's modified AGI exceeds \$160,000. The president proposes to index the phase-out limits for tax years beginning after December 31, 2010. The president also recommends indexing the expense amounts for the AOTC for inflation for tax years beginning after December 31, 2010.

**Impact** *With the proposed inflation adjustment, the difference between the AOTC and the former Hope education credit (which would otherwise apply as early as against next year's spring semester tuition) might make or break a student's choice of post-secondary education. The Hope credit was \$1,800 with a phase-out starting at \$50,000 (\$100,000 for joint filers), while the AOTC caps out at \$2,500 with a phase-out starting at \$80,000 (\$160,000 for joint filers).*

### Individual Extenders

The president did not identify specific individual provisions for extension but it is likely that Congress will pass the following "extenders" sometime in 2010 and make them retroactive to January 1, 2010:

- An alternative minimum tax (AMT) "patch" for 2010 to keep the exemption high enough to prevent an additional 20 million middle-income taxpayers from having to pay AMT;
- State and local sales tax deduction;
- Teacher's classroom expense deduction of up to \$250 annually;
- Higher education tuition deduction for post-secondary education with income phase-outs;
- Tax-free charitable distributions from IRAs for individuals age 70 ½ and older for distributions up to \$100,000 (in lieu of a charitable deduction);
- Additional standard deduction for real property taxes for non-itemizers; and

- District of Columbia first-time homebuyer's credit.

**Comment** The president did not propose to extend the now-expired \$2,400 exclusion for unemployment benefits received in 2009. For more details about the extenders, see the CCH Tax Briefing: *Extenders Legislation on CCH Intelliconnect and the CCH Tax Research Network.*

## RETIREMENT SAVINGS

### Automatic Enrollment in IRAs

Employers that do not offer a retirement savings plan would be required to enroll their employees in a direct-deposit IRA. Businesses in existence for less than two years and businesses that have fewer than 10 employees would be exempt from this mandatory requirement. Employees would be able to opt-out. Contributions would be made on a payroll-deduction basis and would count toward any enhanced saver's credit to which the employee may be entitled. Additionally, qualified employers would be able to claim a temporary credit of \$25 per participating employee, up to a total of \$250 per year for two years.

**Impact** *To give employers and employees time to adjust to this savings method, the president's proposal would be effective January 1, 2012. The automatic enrollment feature is already an option for 401(k) plans.*

### Small Employer Plans

Current law provides qualified small employers (employers with no more than 100 employees) a tax credit equal to 50 percent of the employer's start-up expenses of establishing or administering a retirement plan. The maximum credit is \$500 per year for three years. The president proposes to raise the maximum credit to \$1,000 per year for three years. The enhanced credit would

be available for tax years beginning after December 31, 2011.

### Saver's Credit

The saver's credit rewards lower and moderate income taxpayers who contribute to retirement savings plans, including traditional and Roth IRAs, qualified plans, qualified cash or deferred arrangements, and other arrangements. The credit offsets part of the first \$2,000 in contributions. The amount of the credit is equal to the credit rate (50, 20, or 10 percent) times the amount of qualified retirement savings contributions (not to exceed \$2,000). The credit rate depends upon the taxpayer's filing status and AGI. The maximum saver's credit is \$1,000 (\$2,000 for married couples).

The president proposes to make the credit fully refundable. Additionally, the credit would be converted to a 50 percent match on up to \$500 in qualified retirement savings for individuals (\$1,000 for married couples filing a joint return). Further, the income caps would be raised, ranging from \$32,500 for single filers to \$65,000 for married taxpayers filing jointly.

**Impact** Taxpayers could elect to deposit the match into the IRA or retirement account in

*which they contributed. The \$500/\$1,000 and AGI amounts would be indexed for inflation beginning in 2012.*

## INDIVIDUALS – TAX INCREASES

The president's FY 2011 budget reflects his campaign promise to extend the individual marginal income tax rates enacted in 2001 with the exception of the top two rates. Currently, the top two individual marginal income tax rates are 33 percent and 35 percent respectively. The president proposes to allow the 33 percent and 35 percent rates to expire after December 31, 2010. The top two individual marginal income tax rates would rise to 36 percent and 39.6 percent respectively after December 31, 2010.

The current 10, 15, 25, and 28 percent rates would be made permanent under the president's FY 2011 budget. The 28 percent rate would be expanded to insulate taxpayers from any increases in their taxes because of the rise in the top two rates.

**Impact** The 36 percent and 39.6 percent rates would apply to single individuals with in-

*comes over \$200,000 and married couples filing joint returns with incomes over \$250,000. The \$200,000 amount would be reduced for the standard deduction and one personal exemption and indexed for inflation for 2011. The \$250,000 amount would be reduced for the standard deduction and two personal exemptions and indexed for inflation for 2011. The 39.6 percent rate would start at the inflation-adjusted level now in place for the 35 percent rate, which for 2010 is \$373,650.*

### Capital Gains

For 2010, the maximum tax rate on qualified dividends and capital gains is 15 percent (zero percent for taxpayers in the 10 or 15 percent brackets). The 15 percent and zero percent rates on capital gains will expire after December 31, 2010 and jump to 20 percent for all taxpayers unless Congress steps in. The rate on dividends would change, too, returning to being taxed as ordinary income.

The president proposes raising the maximum tax rate on qualified dividends and capital gains to 20 percent for single individuals with incomes over \$200,000 and married couples filing a joint return with incomes over \$250,000 effective for tax years beginning after December 31, 2010. The 15 percent and zero percent rates would be made permanent for single individuals with incomes up to \$200,000 and for married couples filing a joint return with incomes up to \$250,000 effective for tax years beginning after December 31, 2010.

**Impact** Assuming that the president's proposals should pass and the capital gains rate for higher bracket individuals rises to 20 percent starting in 2011, taxpayers should keep in mind that the capital gain portion of any installment payment received after 2010 would be taxed at the higher rate; the payment date and not the date of sale controls. Likewise,

### Tax Rate Schedules

Income Brackets	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%
<b>Net Capital Gains</b>			
10% - 15% brackets	0%	10%	0%
Middle brackets	15%	20%	15%
Upper two brackets	15%	20%	20%

*capital loss carryovers realized under years in which the maximum net capital gains rate was 15 percent nevertheless can offset capital gains in a post-2010 year that may be otherwise taxed at a 20 percent rate.*

**Impact** *Taxpayers should not overlook the good news on capital gains; not only preservation of the 15 percent rate for middle-class taxpayers, but extension of zero percent rate for those in the 10 or 15 percent income tax brackets. This proposal to extend these rates creates tax planning opportunities not only for adult children but also for elderly parents who find themselves in the lower tax brackets. The zero percent tax rate was first available in 2008.*

### Itemized Deduction Limit

For the 2010 tax year, the limitation on itemized deductions for higher income individuals (known as the “Pease limitation” after the name of the member of Congress who introduced the original sponsoring legislation) is repealed. The president proposes to revive the limitation on itemized deductions for tax years beginning after December 31, 2010, but at a higher income level. The itemized deduction limit would apply to single individuals with incomes over \$200,000 and married couples with incomes over \$250,000.

**Comment** For 2009, the income trigger for both joint and single filers was \$166,800. For 2009, the limitation on itemized deductions was reduced by two-thirds under the phase-out schedule that eliminated it for 2010, after which it will return in full force at the lower levels unless Congress acts.

The president also proposes to limit the tax rate at which itemized deductions reduce tax liability to 28 percent. The proposal would apply to single individuals with incomes over

\$200,000 and to married couples filing a joint return with incomes over \$250,000, effective for tax years beginning after December 31, 2010.

### Personal Exemption Phase-Out

The personal exemption phase-out is repealed for 2010. The president proposes to reinstate the personal exemption phase-out effective for tax years beginning after December 31, 2010.

**Impact** *The president proposes to reinstate the personal exemption phase-out on single individuals with incomes over \$200,000 and married couples with incomes over \$250,000.*

## BUSINESS INCENTIVES

The FY 2011 budget appropriates more than \$100 billion to fund job creation, including a new jobs tax credit, enhanced expensing, 50-percent bonus depreciation, and a permanent research tax credit. The proposals would also extend certain business extender provisions and would increase the tax break on qualified small business stock to 100 percent.

**Comment** Unlike the FY 2010 budget, the new budget does not propose an extended net operating loss (NOL) carryback for small businesses since a modified NOL carryback for 2009 has already been

enacted under the Worker, Homeownership and Business Assistance Act (2009 Worker Act).

### Hiring Tax Credit

The budget proposes \$33 billion in small business jobs and wages tax credits. The tax credit would provide a \$5,000 tax credit for every net new employee hired by a qualified small business in 2010. The total credit will be capped at \$500,000 for any one firm. The proposal would also reimburse small businesses that increase wages or hours for existing employees for the Social Security payroll taxes they pay on real increases in their payrolls, up to the current Social Security maximum wage base of \$106,800.

**Impact** *President Obama predicted that the proposed credit comes at the “perfect time...because the economy is growing, but businesses are still hesitant to start hiring again.” The president added that “employers would actually be able to claim the credit every quarter, as opposed to waiting a whole year.”*

**Comment** Several different versions of a job creation tax credit are being discussed in the Senate. One proposal would provide a tax credit of 20 percent for

### Timeline for Major Tax Changes

Changes:	Year:
Individuals Tax Cut Extensions:	2011
Rate Increase for Higher Brackets	2011
Permanent R&D Credit	2010
LIFO Repeal	2012
International Tax Changes	2010-2013
Small Business Stock	2010
Estate Tax Extension and Enforcement provisions	2010

small employers (those with fewer than 100 employees) and a tax credit of 15 percent for large employers (those with more than 100 full-time employees).

### Code Sec. 179 Expensing

Congress has regularly enhanced Code Sec. 179 expensing in recent years by increasing the maximum deduction amount and the phase-out limit. For 2009, the maximum Code Sec. 179 deduction was \$250,000 and the phase-out limit for qualifying property purchased during the year began at \$800,000. The president proposes extending enhanced Code Sec. 179 expensing at 2009 levels through December 31, 2010. The proposal would extend to qualified property placed in service in a tax year beginning in 2010, the rules under Code Sec. 179 that are in effect for tax years beginning in 2009.

**Comment** Under the president's proposal, off-the-shelf computer software will continue to be considered Code Sec. 179 property for tax years beginning in 2010. Senate Finance Committee ranking member Charles Grassley, R-Iowa, has proposed in his Small Business Tax Relief Act of 2009 an even more aggressive plan to jumpstart equipment purchases by businesses: a \$500,000 limit on the deduction, with a phase-out starting at \$2 million.

### Bonus Depreciation

In tandem with enhanced Code Sec. 179 expensing, Congress has regularly

provided for bonus depreciation. An additional first-year depreciation deduction was allowed for qualified property placed in service in 2009. The deduction, which was allowed for regular and AMT purposes, equaled 50 percent of the cost of qualified property placed in service in 2009 (through 2010 for certain longer-lived (10-year) and transportation property). The president proposes extending the additional first-year bonus.

**Impact** *Extending bonus depreciation into 2010 is one of the most expensive provisions proposed by the president, projected to immediately cost over \$37 billion in 2010-2011, with only a portion of that cost made up before 2020.*

**Comment** The president also proposes extending for one year the now-expired election to claim additional research or minimum tax credits in lieu of the additional depreciation deduction.

### Qualified Small Business Stock

The president's FY 2011 budget proposes to raise, from 75 percent to 100 percent, the exclusion currently available on gain realized on qualified small business stock. The exclusion is intended to help small businesses raise capital. Additionally, the administration would eliminate as an AMT preference item the taxable portion of the gain.

Under the 2009 Recovery Act, individuals and certain noncorporate taxpay-

ers may exclude from taxable income 75 percent of their gains from the sale of certain small business stock acquired after February 17, 2009 and before January 1, 2011. The 75 percent exclusion – which would be retroactively raised to 100 percent – would be available for qualifying small business stock acquired after February 17, 2009. To be excludable, the stock must be held for five years. To qualify as a small business, the corporation, when the stock is issued, may not have gross assets exceeding \$50 million and may not be an S corporation.

**Impact** *The 100 percent exclusion would result in an effective tax rate of zero percent. This tax break is especially valuable to higher-income taxpayers who can expect, under proposals by the Obama administration, the capital gains tax rate to revert to 20 percent after 2010 (the pre-2003 tax cut rate).*

### Research Tax Credit

The research and experimentation credit, which provides a temporary tax credit of 20 percent of qualified research expenses above a certain base amount (and all eligible payments to energy research consortiums for energy research) expired on December 31, 2009. The administration views the research credit as important to encouraging technological developments important to economic growth. The president proposes to make the research credit permanent.

**Impact** *Making the research credit permanent has been proposed numerous times over the course of the last several years, including by the Bush administration. However, making the research credit permanent is estimated to cost \$82.6 billion over ten years. The "sticker shock" of this tax break, especially in light of the economic recession, is likely to compel Congress to continue keeping it temporary.*

## Major Revenue Raisers (2010-2019)

Upper Bracket Rate Increases	\$969 billion
International Tax Changes	\$122 billion
Financial Institutions Provisions	\$93 billion
Eliminating All Fossil Fuel Preferences	\$38.8 billion
Compliance and Enforcement	\$25.6 billion

## Cell Phones

The administration proposes to remove cell phones from their current classification as listed property, thereby lifting the strict substantiation requirements of use and the additional limits placed on depreciation deductions. In addition, the fair market value of personal use of a cell phone (or other similar device) provided to an employee predominantly for business purposes would be excluded from gross income.

**Impact** *This “listed property” designation was imposed on cell phones when they were novel, expensive, and not many individuals owned one. Today, not only are cell phones widely available and used, but necessary for doing business. The IRS Commissioner announced in early January that the IRS would call a temporary halt to enforcing strict substantiation on cell phone use until Congress makes good on its leadership’s promise to pass remedial legislation.*

## Business Extenders

The president’s FY 2011 budget specifically identifies some business tax breaks for extension through December 31, 2011. 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);
- Qualified leasehold improvements (improvements eligible for a 15-year Modified Accelerated Cost Recovery System (MACRS) recovery period);
- Qualified restaurant improvements (eligible for a 15-year MACRS recovery period); and

- Empowerment and community renewal zones (eligible for special tax incentives, such as tax-exempt financing initiatives).

**Comment** Other business extenders, such as brownfields remediation, the Indian employment credit, and more, are also likely to be extended by Congress sometime in 2010 and made retroactive to January 1, 2010. *For more details about the business extenders, see the CCH Tax Briefing: Tax Extenders on CCH Intelliconnect and the CCH Tax Research Network.*

**Comment** The president proposes to permit the New Markets Tax Credit to offset AMT liability and allocate \$5 billion for each of 2010 and 2011.

## Cash Assistance to States in Lieu of Low Income Housing Tax Credits

Under the 2009 Recovery Act, a state may elect to receive a cash amount in lieu of a portion of the state’s 2009 low income housing tax credit (LIHTC) credit ceiling. The president proposes to allow states to elect cash assistance in lieu of LIHTCs for 2010.

## Advanced Energy Manufacturing Projects

Taxpayers investing in eligible property used in a qualifying advanced energy project may qualify for a tax credit. The president proposes providing an additional \$5 billion of tax credits for investment in qualified property used

in a qualifying advanced energy manufacturing project. The change would be effective on the date of enactment.

## FINANCIAL INSTITUTIONS/PRODUCTS

### Financial Crisis Responsibility Fee

The president’s FY 2011 budget includes his controversial “financial crisis responsibility fee” on the liabilities of financial institutions with at least \$50 billion in consolidated assets. The rate of the fee applied to covered liabilities would be approximately 15 basis points. The president proposes to make the fee effective as of July 1, 2010.

**Impact** *The fee would be applied to banks, thrifts, bank and thrift holding companies, brokers, and securities dealers. U.S. firms owning or controlling these types of entities as of January 14, 2010 would also be subject to the fee. Financial firms not based in the U.S. would be subject to the fee based on the liabilities of their U.S. subsidiaries.*

### Forward corporate stock sales

Generally, corporations do not recognize gain or loss on the issuance or repurchase of their own stock. The president proposes to require a corporation that enters into a forward contract to sell its own stock to treat a portion of the payment received when the stock is issued as a payment of interest. The proposal would be effective for forward contracts entered into after December 31, 2011.

## Major Expenditures (2010-2019)

Tax Cuts for Individuals	\$143 billion
Tax Cuts for Businesses	\$93.4 billion
Economic Recovery Measures	\$47.5 billion

**Comment**

Income tax is currently imposed on a portion of the payment when corporations declare a future stock issue, but receive immediate payment from the investor.

### Commodities, Securities and Other Dealers

Generally, certain dealers in commodities, securities, commodities derivatives, and equity options must treat the income from Code Sec. 1256 contracts entered into in their capacity as a dealer as generating 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. The president proposes to end this treatment effective for tax years beginning after the date of enactment. Affected dealers in commodities, securities, commodities derivatives, and equity options would be required to treat the income from their day-to-day dealer activities in Code Sec. 1256 contracts as ordinary in character and not as capital in character.

### Repurchases of Convertible Debt

Code Sec. 249 may operate to limit or disallow a corporation's deduction of amounts used to repurchase convertible debt if the debt instrument is convertible into its stock or stock of a corporation in control of, or controlled by, the corporation. "Control" is determined by reference to Code Sec. 368(c). The president proposes to amend the definition of control in Code Sec. 249 to incorporate indirect control relationships of the nature described in Code Sec. 1563(a)(1).

## INSURANCE COMPANIES/PRODUCTS

### Sales of Life Insurance Contracts

The FY 2011 budget would require the purchaser of an interest in an existing life insurance policy with a death benefit of at

least \$500,000 to report the purchase price and other information to the IRS. The insurance company would also have to report the payment of benefits to the buyer. In addition, the proposal would modify the transfer-for-value rules to ensure that exceptions do not apply to buyers of policies.

### Dividends-Received Deduction

The president proposes to modify the dividends-received deduction for life insurance company separate accounts. Under current law, the deduction may exceed the company's economic interest in its net investment income.

### Corporate-Owned Life Insurance

The president proposes to expand the disallowance of interest expense deductions for funds borrowed to purchase corporate-owned life insurance (COLI) contracts on employees, officers and directors. The proposal would apply to contracts issued after December 31, 2010.

**Impact**

*The change, the administration predicted, would deter companies from investing in investment-oriented insurance policies by borrowing from sources other than the contracts themselves.*

### Annuities

The president proposes to permit partial annuitization of a nonqualified, deferred annuity contract in an exchange of annuity contracts. The proposal would provide for consistent treatment of these transactions and be effective for partial annuitizations that are effected after December 31, 2010.

## INTERNATIONAL TAX REFORM

One focal point for tax legislation in 2010 will be on preventing "international tax avoidance." The president's FY 2011

budget proposes to increase U.S. tax revenues from foreign-based income. It also takes aim at reducing the tax incentives for U.S. companies to shift investments, earnings and jobs overseas.

**Impact**

*Many proposals on the international front mirror recommendations made in last year's budget. One major difference, however, is that, a year later, the Treasury Department has completed a year-long hiring blitz of a substantial number of experts in international taxation. With that structure in place, the administration is now prepared to work with Congress, as well as within its existing regulatory authority, on a vigorous international agenda. Major changes are expected in 2010 and 2011.*

### Deferred Interest Expense

U.S. taxpayers have been able to deduct interest expenses allocable to foreign-source income, even if the expenses exceed the income or there is no foreign-source income. The president proposes to defer the deduction of interest expense apportioned to foreign-source income that is not currently subject to U.S. tax. The deferred expense would be deductible only in a subsequent year when the foreign-source income is subject to U.S. tax.

**Impact**

*The Obama administration indicates that the current tax benefits may encourage U.S. businesses to shift investments and jobs overseas, "harming our domestic economy."*

### Foreign Tax Credit

The foreign tax credit limitation is applied separately to foreign income in the passive category and the general category. A domestic corporation is deemed to pay the foreign taxes paid by a foreign subsidiary that pays it a dividend. The president would take a dual approach to prevent manipulation of the foreign tax

credit. One proposal would determine the deemed-paid foreign tax credit based on the amount of consolidated earnings and profits repatriated to the U.S. taxpayer. Another proposal would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

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

### Transfer Pricing

Companies are shifting income through transfers of intangible assets to low-taxed affiliates, resulting in a significant erosion of the U.S. tax base, according to the administration. One proposal would attack excessive income shifting by treating “excessive returns” as subpart F income in a separate foreign tax credit limitation.

Another proposal would clarify that intangible property includes workforce in place, goodwill, and going concern value. In addition, the IRS may value intangible property by considering profits or prices from a “realistic alternative” to the controlled transaction.

**Impact** *American know-how, reputation, and trained personnel are assets that the administration does not want shipped overseas without a higher return on those assets from tax revenues. The transfer-pricing proposal takes special aim at preventing inappropriate avoidance of taxes under Code Sections 367(d) and 482.*

### Reinsurance Transactions

Reinsurance transactions with foreign affiliates not taxed in the U.S. on insurance income can provide substantial tax advantages over similar transactions with entities taxed in the U.S. The president proposes to deny a deduction for reinsurance premiums paid to affiliated foreign

reinsurance companies on U.S. risks. Alternatively, the foreign corporation could elect to treat the premium received as effectively connected income.

### Earnings Stripping

Code Sec. 163(j) limits the deductibility of certain related-party interest. However, under current law, companies can reduce U.S. taxes through the use of a foreign entity holding related-party debt. A Treasury study found strong evidence of the use of such techniques by expatriated entities (a U.S. entity that is replaced with a foreign parent). The president proposes to tighten the statutory limitations on the deduction of interest by an expatriated entity to related persons.

### Withholding Tax

The president proposes to repeal the 80/20 company provisions. These provisions have provided a limited exception to the rules requiring withholding on dividends and interest paid by a U.S. corporation to a foreign person. International investment companies have found inventive ways lately to significantly broaden this “limited” exception.

**Impact** *While U.S.-source income and gains paid on U.S. stock may be subject to 30 percent U.S. withholding, similar earnings from an equity swap are treated as foreign-source income and are not subject to withholding. The proposal would ensure that economically equivalent transactions are taxed in the same manner.*

### Taxes on Foreign Oil and Gas

Taxpayers that pay taxes on foreign oil and gas income are not subject to double taxation when they are receiving a specific economic benefit for the payment. The administration believes that existing law fails to achieve an appropriate split when a single payment is made to a foreign country. For example, where the country imposes a levy only on oil and gas income or imposes a higher levy on oil and gas income. The president

proposes to limit the application of the foreign tax credit for amounts paid by “dual-capacity” taxpayers.

### Foreign Accounts and Trusts – Reporting and Withholding

According to the administration, some Americans have evaded their tax responsibilities by hiding income in a foreign bank account, trust or corporation. The FY 2011 budget would strengthen the information reporting and withholding requirements for income earned abroad.

**Impact** *Hidden foreign assets have been a major target of the IRS and Congress, which see growing evidence of tax evasion in this area ... as well as the opportunity to bring significant revenues into the Treasury. The IRS Commissioner has estimated revenues “in the billions” from the agency’s recent pursuit of Swiss account holders alone.*

**Withholding.** One FY 2011 budget proposal would require a withholding agent to withhold tax of 30 percent on payments (of U.S. source income) to foreign financial institutions (FFIs). The FFI would have to report the name, address and taxpayer identification number (TIN) of the U.S. account holder, the account balance, and receipts, withdrawals and payments from the account.

Another proposal would require a withholding agent making a payment of interest or dividends to a foreign entity, or of proceeds from property that can generate interest or dividends, to withhold tax of 30 percent, unless the foreign entity certifies that no U.S. person owns an interest greater than 10 percent, or unless the entity provides the name, address, and TIN of each substantial U.S. owner.

**Comment** Use of technology is also being called upon in the government’s mission to prevent foreign tax evasion. Along with withholding requirements, the administra-

tion would require electronic filing of returns by a financial institution that withholds taxes, effective for returns due after the date of enactment.

**Registered bonds.** Taxpayers can deduct interest on debt. A deduction for interest is allowed for certain bonds if they are in registered form. The administration would eliminate the foreign-targeted exceptions to the registration requirements, to ensure that owners are properly identified and that the income is properly reported. The provision would apply to obligations issued two years after the law's date of enactment.

**Reporting of bank accounts.** Another proposal would supplement but not replace the reporting of foreign bank accounts on Form TD F 90-22.1 (FBAR). Any U.S. individual holding an interest in a foreign financial account, foreign entity, or instrument issued by a foreign person, would have to file an information return if the total assets of all accounts exceed \$50,000. The IRS could impose reporting for domestic entities formed to hold foreign financial assets. Penalties for nonreporting would be at least \$10,000. The proposal would take effect for tax years beginning after the date of enactment.

**Impact** *A rebuttable presumption would be allowed for the IRS in civil actions. If it is established that the individual had an undisclosed foreign account/asset, the aggregate value of the undisclosed account/asset would be presumed to exceed \$50,000.*

**Impact** *Penalties of 20 and 40 percent would be imposed on any understatement of tax attributable to undisclosed foreign financial assets. Moreover, the statute of limitations would be extended to six years for omissions from gross income exceeding \$5,000 attributable to the nondisclosure of foreign financial assets. The extended statute of limitations would apply*

*to returns for which the three-year statute has not expired.*

**Comment** Reporting would not be required where the U.S. financial institution determines that, among other things, the entity making or receiving the transfer is a publicly-traded corporation.

**Trust reporting.** A foreign trust that receives property from a U.S. person would be presumed to have a U.S. beneficiary under the president's overall plan. This presumption will improve the ability of the IRS to enforce U.S. tax rules applicable to foreign trusts. The U.S. transferor can overcome the presumption by filing an information return indicating that neither the trust income nor its corpus benefits any U.S. person. This proposal would apply to transfers of property after date of enactment.

Penalties would also be increased for certain foreign trusts that fail to report transfers to and distributions from the trust.

## "LOOPHOLE CLOSERS"

### Codification of Economic Substance Doctrine

The president proposes to clarify and codify the economic substance doctrine. A transaction would satisfy the economic substance doctrine only if (1) it changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position and (2) the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. Additionally, the proposal would clarify that a transaction will not be treated as having economic substance solely by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net tax benefits arising from the transaction.

**Penalty.** The president also proposes a new 30 percent penalty on an understatement of tax attributable to a transaction lacking economic substance.

The penalty would be reduced to 20 percent if the taxpayer made adequate disclosure of the relevant facts on the taxpayer's return.

**Impact** *The president's proposals are prospective. Clarification and codification of the economic substance doctrine along with the new understatement penalty would apply to transaction entered into after the date of enactment. The denial of the interest deduction would be effective for tax years ending after the date of enactment with respect to transactions entered into after such date.*

**Comment** Codifying the economic substance doctrine has appeared several times as a revenue raising provision in various legislative proposals. Most recently, the House approved codification of the economic substance doctrine as part of its health care reform bill, the Affordable Health Care for America Act (H.R. 3962).

### Carried Interest

The president revived his proposal to tax carried interests as ordinary income. The proposal would apply to a profits interest in a partnership that is received in exchange for services. The services partner would also owe self-employment taxes on income earned on the carried interest. The proposal would be effective for tax years beginning after December 31, 2010.

**Impact** *The proposal is controversial but would be a big money-maker. It is estimated to raise almost \$24 billion through 2020.*

**Comment** The proposal identifies "services partnership interest" (SPI) as the partner's share of income that would be subject to tax as ordinary income. An SPI is a carried interest held by a person who provides services to the partnership.

## COMPLIANCE/ ENFORCEMENT

The administration proposes improvements to achieve greater compliance through many of the same means as proposed in FY 2010. For example, proposals to improve business compliance include mandatory e-filing requirements and enhanced penalties. The administration is also asking for more than \$12.5 billion for IRS operations in FY 2011 that, among other expenditures, reflects almost a \$300 million increase allocated to IRS enforcement programs.

### Information Return Penalties

The president proposes significant increases in information return penalties:

- The first-tier penalty would rise from \$15 to \$30 and the calendar year maximum penalty would increase from \$75,000 to \$250,000;
- The second-tier penalty would double from \$30 to \$60 and the calendar year maximum penalty would rise from \$150,000 to \$500,000; and
- The third-tier penalty would increase from \$50 to \$100 and the calendar year maximum would jump from \$250,000 to \$1.5 million.

Additionally, the minimum penalty for each failure due to intentional disregard would rise from \$100 to \$250. The proposed hikes to the information return penalties would be effective for returns required to be filed after December 31, 2011.

**Impact** *Penalties would be reduced for qualified small filers (whose average gross receipts do not exceed \$5 million). The calendar year maximum first-tier penalty for qualified small filers would be \$75,000; the calendar year maximum second-tier penalty would be \$200,000; and the calendar-year maximum third-tier penalty would be \$500,000.*

### Electronic Filing

The president proposes, as he did in FY 2010, to require all taxpayers that

file Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More) to file their returns electronically. For taxpayers not required to file a Schedule M-3, such as exempt organizations, the president proposes giving the IRS authority to reduce the current threshold for electronic filing from 250 or more returns during the calendar year. The proposal would be effective for tax years ending after December 31, 2010.

Additionally, the president proposes to create an assessable penalty for failure to file electronically where e-filing is mandatory for the corporation or exempt organization. The penalty would be \$25,000 for a corporation. Exempt organizations would be liable for a \$5,000 penalty. The penalty regime would be effective for returns required to be filed electronically after December 31, 2011.

**Comment** The 2009 Worker Act requires paid tax return preparers of more than 10 individual federal income tax returns per year to electronically file those returns effective with all returns filed after December 31, 2010.

### Employment Taxes

The FY 2011 budget establish standards for holding employee leasing companies, also referred to as professional employer organizations, jointly and severally liable with their clients for federal employment taxes. The president also called for establishing standards for holding employee leasing companies solely liable for employment taxes if certain requirements are met. The proposal would be effective for employment tax returns required to be filed with respect to wages paid after December 31, 2010.

**Impact** *The IRS has identified employment taxes as a lucrative "tax gap" area in which to harvest heretofore untapped revenue. The IRS Small Business/Self-Employed (SB/SE) Division*

*recently has begun randomly identifying over 1,000 cases for examination under its National Research Program (NRP) related to employment tax issues. That data will help form the selection criteria for more extensive employment tax audits.*

### FUTA Surtax

The Federal Unemployment Tax Act imposes a 6.2 federal payroll percent tax on the \$7,000 wage base. The rate reflects a 5.4 percent credit for state unemployment taxes, a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax has applied since 1976 and been extended several times, most recently through June 30, 2011. The administration proposes to make the surtax permanent. This will support the continued solvency of federal unemployment trust funds.

### Worker Classification

The president proposes to increase certainty with respect to worker classification (employee or independent contractor) by authorizing the IRS to issue generally applicable guidance on the proper classification of workers under common law standards. Moreover, the proposal would reform section 530 of the Revenue Act of 1978 and allow the IRS to require prospective reclassification of workers who are misclassified. The proposal would be effective on enactment. However, prospective reclassification would not be effective until the first calendar year beginning at least one year after the date of enactment.

Independent contractors receiving payments totaling \$600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold for federal tax purposes a flat-rate percentage of their gross payments. The contractor would select the flat-rate percentage.

**Impact** *The proposal directs the IRS to focus its guidance on industries and jobs where there*

*has been a history of misclassification. Misclassification reportedly will be one of the issues that will be scrutinized within SB/SE's recently launched employment tax audit program.*

### **Criminal Restitution**

Under existing law, court-ordered restitution in criminal tax cases cannot be assessed as a tax. The president proposes, as he did for FY 2010, to allow the IRS to treat court-ordered criminal restitution as tax debt so that collection is easier.

### **Failure to File**

The president proposes to make repeated, willful failures to file a tax return a felony. This treatment would apply to any person who willfully fails to file returns in any three years within any five consecutive years if the aggregated tax liability for the period is at least \$50,000.

### **Bad Check Penalty**

The FY 2011 budget clarifies that the bad check penalty applies to electronic checks and other payment forms. The bad check penalty is two percent of the amount of the bad check or money order. If the bad check or money order is for less than \$1,250, however, the penalty is the lesser of \$25 or the amount of the check or money order.

### **Statute of Limitations**

The president proposes to create an additional exception to the general three-year limitations period for assessments of federal tax liability resulting from adjustments to state or local tax liabilities. The statute of limitations would be extended to the greater of (1) one year from the date the taxpayer first files an amended return with the IRS reflecting adjustments to the state or local tax return or (2) two years from the date the IRS first receives information from the state or local revenue agency under an information sharing agreement.

### **Offers-in-Compromise**

Current law requires taxpayers making lump sum offers-in-compromise (OIC) to provide a nonrefundable payment of 20 percent of the lump sum with the initial offer. If the OIC involves periodic payments, taxpayers must make a nonrefundable payment of the first installment with their initial offer. The president proposes to eliminate the requirement that an initial OIC include a nonrefundable payment of any portion of the taxpayer's offer.

**Impact** *The nonrefundable payment requirements have been criticized as reducing access to the program for many taxpayers, who often cannot afford the upfront down payment.*

### **IRS Levy Authority For Vendor Payments**

The president proposes to expand the levy authority of the IRS in instances where the government purchases or leases goods or services. Current law allows the IRS to levy 100 percent of the payment owed to a federal contractor with unpaid federal tax liabilities for "goods or services sold or leased." Under the president's proposal, the IRS would be authorized to issue levies against 100 percent of payments for real estate or other property not specifically considered a good or service. The proposal would be effective for payments made after the date of enactment.

**Post-levy due process.** The president also proposes to allow the IRS to reduce government payments owed to a contractor prior to a Collection Due Process (CDP) hearing for unpaid employment tax liabilities of the contractor. The proposal would be effective for levies issued after December 31, 2010.

**Impact** *These contractor proposals are in line with the administration's January 22 memorandum announcing a multi-agency initiative to prevent taxpayers delinquent in filing or*

*paying federal income taxes from receiving approvals for bids on government contracts.*

### **Out-of-State Residents**

The IRS may offset federal tax refunds to collect delinquent state income tax obligations if the taxpayer resides in the state collecting the tax. The president proposes allowing the IRS to offset federal tax refunds to collect delinquent state income tax obligations wherever the taxpayer resides. The proposal would be effective on the date of enactment.

## **OTHER REVENUE RAISERS**

### **LIFO Repeal**

Many companies use the last-in, first-out (LIFO) method to determine the value of its inventory and its cost of goods sold (COGS). The LIFO method provides a tax benefit to companies facing rising inventory costs, since the COGS is based on more recent, higher values, resulting in lower taxable income. The administration proposes to repeal the availability of the LIFO method. Companies would be required to revalue their beginning LIFO inventory to its FIFO (first-in, first-out) value in the first taxable year beginning after 2011. Companies would be allowed to take into account this one-time increase in income ratably over 10 years (the FY 2010 budget proposed a seven-year period for recognizing the income).

**Impact** *LIFO repeal would eliminate a tax deferral opportunity for taxpayers with inventories and would simplify the tax code. Repeal would also remove a possible impediment to conforming to the International Financial Reporting Standards (IFRS), which may be adopted by the Securities and Exchange Commission and which do not permit the use of LIFO accounting.*

### Dividends on Reorganization

Current law requires a shareholder receiving boot for stock in a reorganization to recognize gain equal to the lesser of the gain realized or the boot received (the “boot-within-gain” limitation). If the exchange has the effect of a dividend, part or all of the gain is treated as a dividend. The administration would repeal the boot-within-gain limitation for a transaction with dividend effect. The proposal would apply to taxable years after 2010.

**Impact** *This will provide more uniform treatment of dividends, regardless of context. It also will eliminate transactions in cross-border reorganizations that allow U.S. shareholders to repatriate previously untaxed earnings and profits of foreign subsidiaries with little or no U.S. tax.*

### Information Reporting

The president proposes to expand information reporting to help reduce the tax gap. The president has asked Congress to:

- Require information reporting by businesses that make payments to corporations of \$600 or more in a calendar year effective for payments made to corporations after December 31, 2010;
- Require information reporting for rental property expense payments of \$600 or more effective for tax years beginning after December 31, 2010;
- Require information reporting for private separate accounts of life insurance companies effective for tax years beginning after December 31, 2010;
- Require a certified Taxpayer Identification Number (TIN) from contractors receiving payments of \$600 in a calendar year from a particular business, effective for payments made to contractors after December 31, 2010; and
- Authorize the IRS and Treasury Department to require information

reporting on all non-wage payments by federal, state, and local governments to procure property and services effective for payments made after December 31, 2010.

**Comment** If a contractor fails to provide an accurate certified TIN, the business making the payment would be required to withhold at a flat-rate percentage of gross payments. The flat-rate percentage (of 15, 25, 30, or 35 percent) would be selected by the contractor.

**Impact** *The proposed information reporting requirements for rental property expense payments would be similar to the reporting requirements applicable to taxpayers engaged in a trade or business.*

### Punitive Damages

Deductions are currently allowed for both compensatory and punitive damages. The president proposes to eliminate the deduction for punitive damages, to emphasize the punitive aspect of the penalty. The proposal would apply to damages paid or incurred after 2011.

### Lower of Cost or Market Inventory Accounting

Taxpayers may write down the carrying value of their inventories by applying the lower of cost or market inventory accounting method (LCM). The president proposes to repeal the LCM method and the ability to write down the cost of “subnormal” goods. Any accounting adjustment would be included in income ratably over four years, beginning with the year of change. The proposal would apply to tax years beginning after 12 months from the date of enactment.

### Cellulosic Biofuel Producer Credit

The president proposes to exclude so-called black liquor (liquid byproducts from processing paper or pulp) from

qualifying for the income tax credit for cellulosic biofuel. Otherwise, allowing a credit for black liquor would result in substantial revenue losses and a wind-fall for the paper industry. The proposal would apply on the date of enactment.

### ESTATE/GIFT TAXES

While the federal estate tax has officially expired for 2010 (and is officially set to return in 2011 at pre-2001 EGTRRA levels), the president’s FY 2011 baseline budget assumes a reinstatement of the estate tax. The president proposes a retroactive reinstatement of the estate tax to January 1, 2010, at 2009 levels.

**Impact** *The House passed the Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Bill of 2009 (H.R. 4154) to permanently extend the estate tax at 2009 exemption rates. The bill would impose a 45 percent tax on estates above \$3.5 million per individual and \$7 million for married couples. The bill is now in the Senate where, at press time, no action has yet been taken.*

### Anti-Abuse Measures

Working under the assumption that the estate tax is not going away, the administration has made several budget proposals to tighten up reporting and valuation methodology to prevent perceived abuses.

**Recipient Basis.** The president’s FY 2011 budget proposes to impose a new reporting requirement for taxpayers inheriting or receiving property by gift for which valuation is required to determine basis.

Under the president’s FY 2011 proposal, the recipient would be required to report a basis no greater than the value reported by the decedent’s estate for estate tax purposes. Likewise, donees would be required to report a basis in the property no greater than the donor’s basis. Further, to facilitate consistent positions between recipients and the estate’s or donor’s tax return, the budget

would require the executor of the decedent's estate or the donor of a lifetime gift to report the necessary information to both the recipient and the IRS.

**Impact** Typically, donees receive a carryover basis from the donor and estate beneficiaries receive a stepped up basis in property passed through the estate. In either case, the recipient's gain on eventual disposition of the asset may be reduced to the extent that the recipient is prepared to argue the asset should be valued higher than the value reported on the estate or gift tax return. The reporting proposal eliminates the possibility of the IRS getting whipsawed on valuation without knowing it.

**Comment** A modified carryover basis regime is technically now in place for estate assets exceeding \$1.3 million as a replacement for the repealed estate tax. This modified regime is expected to be repealed along with reinstatement of the estate tax.

**Valuation Discounts.** The president's FY 2011 budget also proposes changes that would enhance the IRS's ability to halt use of a variety of "restrictions" used to lower the value of assets placed in family limited partnerships and other entities. The president recommends creating an additional category of restrictions—"disregarded restrictions"—that the IRS can ignore when valuing an interest in family-controlled entities.

**Impact** These restrictions, which are left to the IRS to develop in regulations, would allow the IRS to ignore for valuation purposes, among other things, a family member's right to liquidate the interest, ability to be admitted as a full partner, and ability to hold equity interest in the entity.

**GRATs.** The president's budget also proposes to restrict current use of grantor retained annuity trusts (GRATs) to artificially reduce overall gift and estate tax in certain intra-family transfers. Specifically, the president's proposal states that some further "downside risk" will be imposed by requiring a GRAT to have a minimum 10-year term, carry a remainder interest with a value greater than zero, and prohibit any decreases in annuity payments during the GRAT term.

**Impact** These restrictions are proposed to be imposed only for trusts created after the date of enactment.

## ENERGY TAXES

### Superfund Taxes

Superfund excise and environmental income taxes, which help remediate hazardous waste sites, expired after December 31, 1995. The president proposes to revive Superfund taxes for 10 years commencing with tax years beginning after December 31, 2010.

### Fossil Fuel Tax Preferences

At the G-20 conference in Pittsburgh in 2009, the president agreed to phase out tax benefits related to the production of fossil fuels as an energy source. In response, the FY 2011 budget proposes to repeal a number of energy tax incentives effective for tax years beginning after December 31, 2010. They are:

- 15 percent investment tax credit for enhanced oil recovery projects;
- Production tax credit for oil and natural gas from marginal wells;
- Expensing of intangible drilling costs and 60-month amortization of capitalized intangible drilling costs;
- Expensing and 60-month amortization of exploration and development costs relating to coal and other hard mineral fossil fuels;
- Deduction for qualified tertiary injectant expenses;

- Exception from passive loss activity rules for working interests in oil and natural gas properties;
- Percentage depletion deduction for the capital costs of oil and natural gas wells, coal, and other hard mineral fossil fuels;
- Code Sec. 199 domestic manufacturing deduction for oil and natural gas production, coal and other hard mineral fossil fuels; and
- Capital gain treatment for coal and lignite royalties.

**Comment** The president also proposes to increase the amortization period for geological and geophysical expenditures incurred by independent producers in connection with oil and gas exploration in the U.S. from two to seven years, effective for amounts paid or incurred after December 31, 2010.

## OTHER INITIATIVES

### Build America Bonds

The president proposes to make permanent the Build America Bond program, which was created under the 2009 Recovery Act. The proposal would make the program permanent at a federal subsidy level of 28 percent of the coupon interest on the bonds effective as of January 1, 2011.

The proposal would also expand upon the eligible uses for Build America Bonds.

**Comment** According to the administration, more than \$64 billion in Build America Bonds were issued through December 2009.

### New York Liberty Zone

After the 9-11 attacks, Congress enacted a number of tax incentives to help the "New York Liberty Zone" recover from the attacks. The president proposes to restructure some of the Liberty Zone tax incentives. Tax credits would be provided to New York State and New York City for expenditures relating to the construction

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or improvement of transportation infrastructure in, or connecting to, the New York Liberty Zone. The proposal would be effective on January 1, 2011.

**Comment**

The New York Liberty Zone is that area of lower Manhattan most affected by the 9-11 attacks.

### Unemployment Insurance Integrity

The president proposes to allow states to redirect up to five percent of recoveries of overpayments of unemployment insurance benefits to additional enforcement activity. Additionally, the FY 2011 budget would require states to impose a penalty of at least

15 percent on recipients of fraudulent overpayments. Revenue from the proposed penalty would be dedicated to additional enforcement activities. The president also would require employers to report a "start work date" to the National Directory of New Hires for all new hires. The proposals would be effective on the date of enactment.

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