A Washington National Tax Services (WNTS) Publication

WNTS Insight

Treasury Department provides "Green Book" explanation of Administration FY 2012 tax proposals

March 9, 2011

Overview

On February 14, the Office of Management and Budget released President Barack Obama's proposed federal budget for Fiscal Year 2012 (the Budget) and the U.S. Treasury Department released its General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, also known as the "Green Book."

The Treasury Green Book provides additional details on various business and individual tax relief and revenue-raising proposals contained in the President's FY 2012 budget. The Administration has reproposed, with certain modifications, a number of tax provisions that were not adopted during the previous Congress.

Research Credit and Other Expiring Business Tax Provisions

The Administration's FY 2012 Budget includes extensions of a number of business tax provisions set to expire at the end of 2011. The Budget proposes to "simplify, expand, and make permanent" the research credit. In addition to making the credit permanent, the Budget proposes to increase the alternative simplified credit rate from 14 percent to 17 percent, effective after 2011. The Treasury Department estimates that the cost of the permanent research credit, as modified, is $106 billion over 10 years.

The Budget also proposes to extend a number of other expiring provisions through the end of 2012, including CFC look-through, Subpart F active financing, and 15-year depreciation recovery for qualified leasehold improvements.

Additional provisions that would be extended for another year include:

- Incentives for biodiesel and renewable diesel, incentives for alcohol fuels, and other energy-related incentives;
- Enhanced charitable deductions for contributions of food, book, and computer inventory;

- The New Market Tax Credits with modifications; and
- Expensing of "Brownfields" environmental remediation costs.

International Proposals

From an international tax perspective, the key items in the Budget for U.S. multinationals continue to be deferral of foreign-related interest expense deductions allocable to unremitted foreign income, pooling of section 902 foreign tax credits, and the "excess return" provision for intangibles transferred outside the United States (to which certain changes have been made). The Budget also includes versions of four other international proposals included in previous Budgets.

Deferral of deductions allocable to unremitted foreign earnings

Under the Administration’s proposal, “foreign-related deductions” of interest expense are allowed only to the extent that expenses and losses are properly allocable or apportionable to *currently taxed* foreign income. Foreign-related deductions properly allocable or apportionable to foreign-source income not currently subject to U.S. tax would be deferred. To the extent that earnings of foreign affiliates are currently remitted to a U.S. company, the proposal increases the foreign allocation of expenses under a gross income method. The proposal would be effective for tax years beginning after 2011.

The Budget does not propose to repeal worldwide interest expense apportionment (WWIA). Legislation enacted in 2009 and 2010 postpones the effective date of WWIA until 2021. Accordingly, the Budget proposal applies through 2020 only to interest expense incurred in the United States. The Joint Committee on Taxation staff (JCT) last year commented that, without WWIA, this interest expense deferral proposal would be an "overcorrection" of any perceived issue involving deduction of U.S. expenses allocable to foreign income.

Unlike an earlier FY 2010 version of the Administration's proposal, the FY 2012 proposal applies an annual approach to computing the expenses disallowed. In other words, the FY 2012 version allows deferred expenses to be deducted in subsequent years as previously deferred foreign earnings are repatriated and subjected to U.S. taxation.

As was the case last year, the Green Book specifies that this proposal does not apply to interest expense properly allocated and apportioned to currently taxed foreign-source income, such as income earned by U.S. companies' foreign branches or income treated as foreign-source under section 863. It is not entirely clear, however, what the impact of that exclusion is, because the Administration has not yet detailed the computational mechanism involved. Under the Budget proposal, the amount of interest allocable and apportionable to foreign-source income is determined pursuant to current Treasury regulations, subject to such revisions as may be necessary to prevent under-allocations to foreign-source income.

The Treasury's revenue estimate for this proposal in FY 2012 is $37.7 billion over 10 years, similar to the JCT's FY 2011 estimate of $35.5 billion but significantly higher than the Administration's FY 2011 estimate of $25.6 billion.

Blending of section 902 foreign tax pools

The Budget proposal, like the Administration's FY 2011 proposal, restricts a U.S.-based multinational group's deemed-paid foreign tax credits under section 902 to the average rate of total foreign tax actually paid on total foreign earnings, thereby eliminating the cross-crediting of high- and low-taxed foreign income. This proposal, which would apply for tax years beginning after 2011, effectively treats all of a taxpayer's CFCs as a single CFC for section 902 purposes.

Observation: A key open question remains under the FY 2012 Green Book with respect to transition rules. The JCT analysis last year questioned whether existing, pre-effective date earnings and tax pools of all CFCs would be combined into a single earnings pool and a single tax pool for purposes of calculating the deemed paid tax credit with respect to post-effective date distributions. Such an approach could have significant tax provision consequences for financial accounting purposes as of the enactment date of the legislation. To the extent that a taxpayer has not made a permanent reinvestment determination with respect to the earnings of its higher-taxed CFCs, on the enactment of such a retroactive averaging regime the taxpayer likely would be underprovided for taxes on such high tax pools unless it can assert permanent reinvestment of those earnings.

Treasury's FY 2012 revenue estimate for this proposal is $51.4 billion over the 10 years, almost $20 billion more than the estimate by the Administration for the FY 2011 version but closer to the FY 2011 JCT estimate of $49.2 billion.

Current Subpart F taxation of "excess returns" attributable to transferred intangibles

To reduce the incentive for taxpayers to engage in certain related-party transactions, the Administration proposes expanding subpart F income to include a new category of "excess income" attributable to intangibles transferred from the United States to low-taxed CFCs. In the Budget, the Administration has modified the FY 2011 version of this proposal, apparently in response to concerns that transfer pricing rules may be inadequate to address value-shifting in outbound transfers of intangibles by U.S. companies.

Under the FY 2012 proposal, if a U.S. person transfers (directly or indirectly) an intangible from the United States to a related CFC (a “covered intangible”), certain excess income from transactions connected with, or benefiting from, the covered intangible is treated as subpart F income "if the income is subject to a low foreign effective tax rate." For this purpose, "excess intangible income" is defined as the excess of gross income from transactions connected with, or benefiting from, such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income, increased by a percentage mark-up. For purposes of this proposal, a transfer of an intangible includes a transfer by sale, lease, license, or through any shared risk or development agreement -- including any cost-sharing arrangement. This subpart F income would be a separate category of income for purposes of determining a taxpayer's foreign tax credit limitation under section 904. This proposal would be effective for transactions in tax years beginning after 2011.

Treasury estimates this proposal to raise $20.8 billion over 10 years. This new estimate is about $5 billion more than the Administration's estimate for the FY 2011 version of this provision, and more than $10 billion higher than JCT's revenue estimate last year.

Observations. The changes to this proposal for FY 2012 apparently were made with the intent of making a closer connection between the transferred intangibles and the "excess income." The FY 2012 Green Book also clarifies certain issues, such as the definition of excess income and the types of transfers that might be subject to this proposal. The scope of transfers seems very broad and raises questions as to whether, for example, intangibles developed under a cost-sharing arrangement can be viewed as having been "transferred" at all. Moreover, certain questions remain open, such as what constitutes a "low foreign effective tax rate" and what percentage mark-up would appropriately be added. In any case, it appears that CFCs would need to analyze their returns on intangibles to determine what amounts may be specifically attributable to transfers covered by the new proposal, if enacted.

Limits on income-shifting through outbound transfers of intangibles

The FY 2012 Budget retains a proposal made in the FY 2010 and 2011 Budgets intended to "prevent inappropriate shifting of income outside the United States" by "clarifying" that the definition of intangible property for purposes of sections 367(d) and 482 includes workforce-in-place, goodwill, and going concern value, effective for tax years beginning after 2011. Prior JCT analysis suggests that foreign goodwill would still enjoy an exception.

The proposal also allows the IRS to value intangible properties on an aggregate basis "where that achieves a more reliable result." As in FY 2011, the proposal states that the IRS "may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken."

Treasury estimates this provision to raise $1.7 billion over 10 years, an increase of $500 million over the FY 2011 Budget estimate, and $1.2 billion more than JCT's FY 2011 estimate.

Observations. This proposal has not changed since FY 2011 and continues to reflect an ongoing Treasury concern about the transfer of U.S.-owned intellectual property to foreign affiliates. That concern is evident in the proposal above for a new category of Subpart F income, as well as administrative guidance (*see* TAM 200907024) and tax litigation (*see First Data Corp v. Commissioner*). Although JCT's analysis of the FY 2010 Budget proposals suggested that a significant tightening of section 482 was needed in this area, JCT did not include similar comments as to the FY2011 Budget proposal.

Modifying the tax rules for dual-capacity taxpayers

The FY 2012 Budget proposal allows a dual-capacity taxpayer - i.e., a taxpayer that is subject to a foreign levy and that also receives a specific economic benefit from the levying country - to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual-capacity taxpayer. The proposal replaces the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax.

The proposal also converts the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The Green Book states that the proposal is not intended to override U.S. treaty obligations to the extent that they allow a credit for taxes paid or accrued on certain oil or gas income. The proposal would be effective for tax years beginning after 2011.

Treasury estimates this provision to raise $10.8 billion over 10 years, an increase of $2.3 billion over the FY 2011 Budget estimate, and $2.6 billion more than JCT's FY 2011 estimate.

Observations. This proposal, which is unchanged since FY 2010, would apply primarily to taxpayers in the oil and gas industries and thus affect a relatively small group of companies. Nevertheless, as reflected in the revenue estimate, the tax impact on those companies would be significant.

Disallowance of the deduction for non-taxed reinsurance premiums paid to affiliates

This proposal (1) denies an insurance company a deduction for reinsurance premiums paid to an affiliated foreign reinsurance company to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received and (2) excludes from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that is paid a premium from an affiliate that otherwise is denied a deduction under this proposal is permitted to elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States and attributable to a permanent establishment for tax treaty purposes. For foreign tax credit purposes, reinsurance income treated as effectively connected under this rule is treated as foreign-source income and is placed into a separate category within section 904. This proposal would be effective for policies issued in tax years beginning after 2011.

Treasury estimates this provision to raise approximately $2.6 billion over 10 years. The current proposal is estimated to raise significantly more revenue than the FY 2011 proposal (which was estimated to raise $519 million over 10 years), presumably because of its potentially broader reach.

Observations. An earlier version of this proposal appeared in the FY 2011 Green Book. However, there are significant differences between the FY 2011 and FY 2012 proposals.

First, according to the FY 2011 Green Book, the U.S. insurance company is denied a deduction only to the extent that the amount of nontaxed reinsurance premiums (net of ceding commissions) paid to foreign reinsurers exceeds 50 percent of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business. The current proposal does not contain this 50-percent threshold. On the other hand, unlike the FY 2011 proposal, the current proposal excludes from the ceding company's income ceding commissions and reinsurance recoveries in the same proportion as the denied deduction. Further, the FY 2011 proposal did not mandate separate basket treatment under section 904 for reinsurance income, which is treated as effectively connected income under the current proposal.

Limits on earnings stripping by expatriated entities

Section 163(j) generally limits the ability of certain corporations to deduct currently interest paid to certain related entities. Specifically, a corporation that has a debt-to-equity ratio greater than 1.5 to 1 (the 1.5 to 1 ratio is considered a "safe harbor") and net interest expense in excess of 50 percent of its adjusted taxable income is subject to the earnings-stripping deduction limitations of section 163(j) for the excess interest.

The Budget proposal revises section 163(j) to limit further the deductibility of interest paid to related persons by a U.S. subsidiary of an expatriated entity, effective for tax years beginning after 2011.

The proposal defines an "expatriated entity" by applying the rules of section 7874 as if such rules were applicable for tax years beginning after July 10, 1989 (the date on which section 163(j) was enacted). However, the revised definition does not apply if the "surrogate foreign corporation" is treated as a domestic corporation under section 7874. For U.S. subsidiaries of expatriated entities, the proposal tightens the cap on interest deductibility for the limitation (reducing the threshold from 50 percent to 25 percent of adjusted taxable income); repeals the debt-to-equity safe harbour; reduces the indefinite disallowed interest carryover period to 10 years; and repeals the three-year excess limitation carryforward period.

Treasury estimates this provision to raise approximately $4.2 billion over 10 years.

Corporate Proposals

Repeal of "boot within gain" limitation for dividends received in certain reorganizations

Under current law, shareholders in a reorganization recognize income (either capital gain or dividend income) to the lesser of the amount realized or the "boot" (generally nonstock consideration) received.

Effective for tax years beginning after 2011, the proposal repeals the so-called "boot within gain" rule if the receipt of boot in a reorganization has the effect of a distribution of a dividend.

Observation: While the proposal likely would affect many related-party asset reorganizations in which boot is issued, the proposal also could change the tax treatment of asset reorganizations of public companies by potentially causing target corporation shareholders to recognize income in excess of the gain realized.

Treasury estimates this provision to raise approximately $849 million over 10 years.

Repeal of nonqualified preferred stock (NQPS) designation

Section 351(g) was enacted in 1997 to modify certain nonrecognition provisions generally to provide for recognition of gain upon the receipt of NQPS. The 1997 amendment reflected a belief that such stock more appropriately represented debt rather than equity. The Administration believes that the 1997 amendment, while a trap for the unwary, allows well-advised taxpayers to issue NQPS in transactions inconsistent with the original purpose of the 1997 provision in order to reduce taxes by recognizing losses through related-party transactions.

The proposal would be effective for stock issued after 2011. Treasury estimates this provision to raise approximately $872 million over 10 years.

Elimination of capital gains taxation on investments in small business stock

To spur investments in small business, Congress in 1993 added Code section 1202, which excludes 50 percent of gain recognized on sale (other than by a corporation) of qualified small business stock. In response to the Administration's proposals for FY 2010 and 2011, Congress modified section 1202 to provide for a 75-percent exclusion for small business stock acquired between February 18, 2009, and September 27, 2010, and a 100-percent exclusion for stock acquired after September 27, 2010, and before January 1, 2012.

The Budget proposal makes permanent the 100-percent exclusion. Treasury estimates this provision to reduce revenues by $5.41 billion over 10 years.

Modification of definition of "control" for purposes of Section 249

Section 249 disallows a deduction for any premium (in excess of normal call premiums for nonconvertible debt) paid on repurchase of certain debt instruments to the extent such instrument was convertible into equity of the issuer or a corporation in control of or controlled by the issuing corporation. Control for this section is defined in section 368(c) as stock representing at least 80 percent of the voting power of all voting shares and at least 80 percent of the value of all nonvoting shares; there is no attribution for purposes of testing control.

The Budget proposal amends the definition of control in section 249 to incorporate indirect control relationships of the nature described in section 1563(a)(1) relating to parent-subsidiary controlled groups, effective on the date of enactment.

Treasury estimates this provision to raise approximately $174 million over 10 years.

Partnership Proposals

Taxation of "carried interest" as ordinary income

Under current law, the character of items of income, gain, loss, and deduction generally flow through from a partnership to the partners. The sale of a partnership interest generally is treated as a capital gain or loss.

The Administration's carried interest proposal taxes a partner's share of income from an "investment services partnership interest" (ISPI) as ordinary income, regardless of the character of income that flows through from the partnership, effective for tax years beginning after 2011. The proposal also requires the partner to pay self-employment taxes with respect to such income. Under the proposal, disposition of the carried interest generally requires recognition of gain as ordinary income.

Under the proposal, a partnership is defined as an investment partnership if the majority of its assets are investment-type assets, but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property held for the production of income. Income attributable to "invested capital" generally is not recharacterized under the proposal. Special rules apply to interests that attempt to replicate the effects of the partnership interest ("disqualified interests").

Treasury estimates this provision to raise $14.8 billion over 10 years.

Observations. The description of this year's proposal appears substantially similar to legislative proposals previously proposed in Congress. Previous versions of the Administration's proposal were much broader than the previously proposed carried interest bills considered in the House and Senate. The proposals from prior years would have applied to all service partnerships, no matter what kind of assets they hold, rather than being limited to partnerships with a majority of investment-type assets.

Revision and simplification of the "fractions rule"

Section 514(c)(9) excepts indebtedness incurred by a "qualified organization" in acquiring or improving any real property from the general section 514 rule that tax-exempt organizations recognize unrelated business taxable income with respect to debt-financed property. If a qualified organization invests in real property through a partnership, to qualify under section 514(c)(9) the partnership must consist entirely of qualified funds, have entirely pro rata allocations, or have allocations that satisfy the "fractions rule." The fractions rule generally provides that the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any tax year greater than such partner's share of the overall partnership loss for the tax year for which such partner's loss share will be the smallest, and each such allocation with respect to the partnership must have substantial economic effect under section 704(b).

The Administration states that the fractions rule has been criticized as extremely complicated and unnecessarily burdensome for qualified organizations failing to meet the test. The Administration proposal replaces the fractions rule with a rule that requires each partnership allocation to have substantial economic effect and no allocation to have a principal purpose of tax avoidance. The proposal states that the IRS is granted regulatory authority to eliminate the "cliff effect" of a technical violation of the rule. The proposal would be effective as of the date of enactment.

Treasury estimates this proposal to reduce revenues by $174 million over 10 years.

Accounting Proposals

Repeal of LIFO inventory accounting

The Budget proposal disallows use of the last-in, first-out (LIFO) inventory method of accounting for Federal income tax purposes. Under the proposal, taxpayers currently using LIFO are required to "write up" their inventories for the first tax year beginning after 2012 and would take the one-time increase into income ratably over 10 years.

Treasury estimates this proposal to raise $52.8 billion over 10 years.

Repeal of lower-of-cost-or-market (LCM) inventory accounting

Under this proposal, taxpayers no longer are permitted to write down inventories when replacement costs fall below historical costs or the inventory being held becomes subnormal. For tax years beginning after 2012, taxpayers are prohibited from using the LCM and subnormal goods methods, and any offsetting adjustment resulting from the change is taken into account ratably over a four-year period beginning with the year of change.

Treasury estimates this provision to raise $8.1 billion over 10 years.

Energy Proposals

The FY 2012 Budget proposes to eliminate a number of tax incentives relating to fossil fuels.

Oil and gas. The Budget proposals:

- repeal the enhanced oil recovery (EOR) credit
- repeal the credit for oil and gas produced from marginal wells
- repeal expensing of intangible drilling costs (IDCs)
- repeal the deduction for tertiary injectants
- repeal the exception to the passive loss limitation for working interests in oil and natural gas properties
- repeal percentage depletion for oil and natural gas wells
- repeal the domestic manufacturing deduction (section 199) for oil and natural gas companies
- increase the geological and geophysical amortization period for independent producers to seven years.

Coal. The Budget proposals:

- repeal expensing of exploration and development costs
- repeal percentage depletion for hard mineral fossil fuels
- repeal capital gains treatment for royalties
- repeal the domestic manufacturing deduction for coal and other hard mineral fossil fuels.

These proposals generally would take effect either with respect to costs paid or incurred after 2011, or for tax years beginning after 2011.

Treasury estimates that elimination of all these fossil-fuel provisions would raise $46.1 billion over 10 years.

Superfund taxes

The Budget proposes to reinstate Superfund excise taxes and a Superfund environmental income tax. These taxes, which were last imposed before 1996, would be reinstated for periods after 2011 and before 2022.

Treasury estimates that the Superfund excise taxes would raise $8.1 billion over 10 years, and the Superfund environmental income tax would raise $12.66 billion over 10 years.

Additional tax credits for qualified investments in advanced energy manufacturing projects

The American Recovery and Reinvestment Act of 2009 ("ARRA") added section 48C, which provides a 30-percent credit for investments related to qualifying advanced energy projects of the taxpayer. Qualifying projects had to be certified by the Treasury Department and the Department of Energy. ARRA capped the total amount of certified credits available to $2.3 billion.

The Budget authorizes an additional $5 billion in credits, authorized for investments in eligible property used in such qualifying projects. The change would be effective on the date of enactment.

Tax credits for energy-efficient commercial building property expenditures

Under section 179D, taxpayers may currently deduct the cost of energy-efficient commercial building in the year in which the property is placed in service. The deduction, which expires after 2013, is limited to either $1.80 or $0.60 per square foot for a qualifying building, based on the percent of energy savings.

The Budget eliminates the accelerated deduction and instead provides tax credits equal to the cost of the property that is certified as being installed as part of a plan to reduce certain energy and power costs. The credit is limited on a scaled basis of $0.60, $0.90, and $1.80 per square foot for energy-efficient commercial property designed to reduce specified total annual energy and power costs by at least 20 percent, 30 percent, and 50 percent, respectively, in comparison to a reference building. The tax credit would be available for property placed in service during calendar year 2012.

Treasury estimates that this proposal would lose $1 billion over 10 years.

Financial Proposals

In addition to the section 249 proposal discussed above, the Budget includes the following proposals to reform the tax treatment of financial institutions and products.

Financial Crisis Responsibility Fee

Because the Administration believes that excessive risk undertaken by major financial firms was a significant cause of the recent financial crisis, the Budget would impose a "Financial Crisis Responsibility Fee" on certain liabilities of the largest firms in the financial sector, effective as of January 1, 2013. The fee would be imposed on covered liabilities at a rate of approximately 7.5 basis points. Taxpayers could deduct the fee when computing corporate income tax.

Treasury estimates this proposal to raise $30 billion over 10 years.

Accrual of income on forward stock sales

Because the Administration believes it is inappropriate to treat differently a corporation's current sale of its stock for deferred payment and its forward sale of the same stock -- transactions that are identical except for the timing of the stock issuance -- the Budget requires a corporation that enters into a forward contract to issue its stock to treat a portion of the payment on the forward issuance as a payment of interest. This proposal would be effective for forward contracts entered into after 2011.

Treasury estimates this provision to raise $296 million over 10 years.

Ordinary treatment of income from day-to-day activities of certain dealers

Because the Administration believes there is no reason to treat dealers in commodities, commodities derivatives dealers, dealers in securities, and dealers in options differently from dealers in other types of property, the Administration believes the income from their day-to-day dealer activities should be taxed at ordinary rates and not treated as long-term or short-term capital gain, as income from certain transactions in "section 1256 contracts" is treated under current law. The Budget requires such dealers to treat the income from their day-to-day dealer activities in section 1256 contracts as ordinary in character, not capital, effective for tax years beginning after the date of enactment.

Treasury estimates this proposal to raise $2.7 billion over 10 years.

Build America Bonds and other bond proposals

The Budget proposes to extend and modify the Build America Bond program. The proposal makes the Build America Bond program, as modified, permanent at a Federal subsidy level equal to 28 percent of the coupon interest on the bonds.

Treasury estimates the Build America Bond proposal to reduce revenues by $28 million over 10 years and to increase federal outlays by $59.7 billion over 10 years.

The Budget also proposes to modify rules for certain tax-exempt bonds, including provisions dealing with arbitrage investment restrictions.

Insurance Proposals

In addition to the reinsurance proposal discussed above, the Budget includes the following proposals to reform the treatment of insurance companies and products.

Corporate-owned life insurance (COLI)

To eliminate tax arbitrage benefits that the Administration believes can result when businesses invest in certain insurance products covering the lives of their employees, officers, directors, or owners that produce tax-deferred or tax-exempt income, the Budget repeals the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers or directors, other than 20-percent owners of a business that is the owner or beneficiary of the contracts. This proposal would apply to contracts issued after 2011.

Treasury estimates this proposal to raise $7.7 billion over 10 years.

Dividends-received deduction (DRD)

To eliminate the controversy between life insurance companies and the IRS that the Administration believes can result from the proration method some taxpayers use to determine the "company's share" of dividends received for purposes of computing a taxpayer's DRD, the Budget repeals the existing regime for prorating income between the company's share and the "policyholders' share." Life insurance companies generally would become subject to the DRD limitations applicable to other corporate taxpayers. This proposal would be effective for tax years beginning after 2011.

Treasury estimates this proposal to raise $5.1 billion over 10 years.

Tax Compliance and Tax Administration Proposals

Repeal and modification of 1099 information reporting on payments to corporations and payments for property

Effective for payments made after 2011, the health care legislation enacted last year removed the longstanding regulatory exceptions to information reporting for payments made to corporations and payments for property. The Budget eliminates information reporting for payments for property and limits information reporting for corporations. Under the proposal a business is required to file an information return for payments to corporations (except tax-exempt corporations) for (1) services aggregating $600 or more in a calendar year, and (2) determinable gains aggregating $600 or more in a calendar year. The proposal provides the IRS regulatory authority to make exceptions when "reporting would be especially burdensome." The proposal would be effective for payments made after 2011.

Treasury estimates this provision to reduce revenues by $9.2 billion over 10 years.

Observation*:* Both the House and Senate have approved separate proposals to repeal completely the expanded 1099 business information reporting provision enacted as part of the 2010 health care law. The House approved a bill (H.R. 4) on March 3 that would repeal both the 1099 business information reporting provision for payments made to corporations and a separate 1099 information reporting requirement for rental property expense payments. The Senate in February approved an amendment to Federal Aviation Administration reauthorization legislation (S. 223) that would repeal the 1099 business information reporting provision for payments made to corporations. The House and Senate would have to reconcile their separate proposals to address the 1099 reporting issue at some point this year to prevent the current law reporting provision to become effective in 2012. Full repeal of the 1099 information reporting provision for payments to corporations has been estimated by JCT to reduce revenues by $21.9 billion over 10 years; JCT staff have estimated repeal of the 1099 information reporting requirement for rental property expense payments to reduce revenues by $2.8 billion over 10 years.

Imposition of requirement on contractors to provide certified taxpayer identification number (TINs)

Under current law, a business that in the course of its trade or business makes payments aggregating more than $600 in a calendar year to a non-employee service provider ("contractor") that is not a corporation must report the payment to the IRS and provide the contractor with Form 1099-MISC. The contractor generally must pay estimated and self-employment taxes during the year, and pay any balance due with the contractor's annual income tax return.

The Budget requires a business to collect Form W-9 from the contractor, verify the contractor's TIN with the IRS, and withhold a flat-rate percentage of the gross payments if (1) there is a mismatch between the name and TIN provided by the contractor, (2) the business did not obtain

Form W-9 from the contractor, or (3) the contractor requests withholding. This proposal would be effective for payments made after 2011.

Treasury estimates this proposal to raise $1.1 billion over 10 years.

Revision of offer-in-compromise (OIC) rules

Section 7122 was amended in 2006 to require a nonrefundable prepayment of 20 percent of the offer (or the amount of the first installment in the case of an offer to pay over time) as a condition of making an OIC to settle a tax dispute with the IRS. Because the Administration believes that the nonrefundable pre-payment requirement reduces access to the OIC program, the Budget proposes to eliminate the requirement, effective for OICs submitted after the date of enactment.

Treasury estimates this proposal to raise $25 million over 10 years.

Imposition of penalty for failure to comply with electronic filing requirements

There currently is no specific penalty imposed on corporations and tax-exempt organizations that fail to e-file their returns as required. The Budget would establish a penalty of $25,000 for corporations or $5,000 for tax-exempt organizations that are required to e-file but that file on paper, effective for returns required to be electronically filed after 2011.

Treasury estimates this proposal to raise $9 million over 10 years.

Expansion of electronic filing requirement

Generally, taxpayers are not required to file their returns electronically unless the taxpayer files at least 250 returns during the calendar year. Effective for tax years ending after 2011, the Budget requires all those corporations and partnerships that must file a Schedule M-3 to file their returns electronically, and would provide the IRS regulatory authority to reduce the 250-return threshold for e-filing for other taxpayers and types of returns.

Miscellaneous Proposals

Denial of deduction for punitive damages

Under the Budget, taxpayers could not deduct punitive damages whether incurred upon a judgment or in settlement of a claim. Also, punitive damages paid by an insurer would have to be reported to the IRS. The disallowance would apply to any punitive damage amounts paid or incurred after 2012.

Treasury estimates this proposal to raise $312 million over 10 years.

Revision to worker classification relief provision

A provision (enacted as Section 530 of the Revenue Act of 1978) in current law allows a service recipient to treat workers as independent contractors if certain conditions are met, even though the worker would constitute an employee if the general common law rules applied. This provision does not permit the IRS to issue general guidance addressing worker classification, and may preclude the IRS from reclassifying misclassified workers.

The Budget permits the IRS to require prospective reclassification of workers who are currently misclassified. Additionally, the proposal permits the IRS to issue generally applicable guidance on the proper classification of workers. The proposal is effective upon enactment, but prospective reclassification of those covered by the current special provision would not be effective until the first calendar year beginning at least one year after date of enactment. The transition period could be up to two years for independent contractors with existing written contracts establishing their status.

Treasury estimates this proposal to raise $8.7 billion over 10 years.

Individual Tax Proposals

Ordinary income rates

The Administration supports extending the 2001 and 2003 Bush tax rates only for middle-income taxpayers. The Budget generally defines middle-income taxpayers as joint filers with income of $250,000 or less (at 2009 levels) or single taxpayers with income of $200,000 or less. As a result, beginning in 2013 higher-income individuals would be subject to a 39.6-percent top rate on ordinary income.

Observation: The Health Care and Education Reconciliation Act of 2010 imposed an additional 0.9-percent tax on wages exceeding $250,000 for joint filers ($200,000 for single filers) and a new 3.8-percent tax on net investment income exceeding $250,000 for joint filers ($200,000 for single filers), effective after 2012.

Qualified dividends and net long-term capital gains

Effective for taxable years beginning after 2012, long-term capital gains are set to be taxed at a maximum rate of 20 percent (18 percent for assets purchased after December 31, 2000 and held for over five years) and all dividends are scheduled to be taxed at ordinary income tax rates for taxpayers at all income levels. The Administration has proposed that higher-income taxpayers be subject to a 20-percent rate on both qualified dividends and long-term capital gains. The special 18-percent long-term capital gain rate would be eliminated. The current maximum rate of 15 percent for qualified dividends and long-term capital gains would be extended for all other individual taxpayers.

Note: Treasury estimates that this proposal would reduce revenue by $123.6 billion over 10 years compared with current law, which would tax qualified dividends as ordinary income after 2012.

Alternative minimum tax relief

The Administration supports permanent extension of alternative minimum tax ("AMT") relief for individuals. AMT relief includes indexing for inflation after 2011 for (1) the AMT exemption amount, (2) the income threshold amounts for the 28-percent AMT rate, and (3) the income thresholds for the phaseout of the exemption amounts. AMT relief also includes extension of nonrefundable personal credits.

Treasury estimates this proposal to reduce revenue by $1.5 trillion over 10 years.

Cap on tax savings from itemized deductions for higher-income taxpayers

For tax years beginning after 2011, the Budget proposes that tax benefits associated with itemized deduction be capped at 28-percent tax rates rather than at the marginal tax rate for higher-income taxpayers. For 2012, this limitation would affect taxable income in the 35-percent bracket and a portion of income in the 33-percent bracket.

Treasury estimates this proposal to raise $321.2 billion over 10 years.

Other proposals

Other proposed changes that affect individual income taxes include:

- Expansion of the child and dependent care tax credit (beginning phase-down increased to $75,000 from $15,000)
- Automatic employee IRA enrollment option, for certain employers not offering another retirement plan
- Increase in available tax credit for small employer plan startup costs
- Permanent extension of the American opportunity tax credit (formerly known as the Hope Scholarship Credit)
- Expansion of Short-Time Compensation unemployment program
- Elimination of minimum required distributions for tax-advantaged retirement plan and IRA aggregate balances of $50,000 or less
- Allowance of all inherited plan and IRA accounts to be rolled over within 60 days.

Estate and gift tax provisions

Rates and exclusions

The FY 2012 budget reflects extension of estate, gift, and GST taxes at the 2009 levels for 2013 and beyond - i.e., a return to a maximum rate of 45 percent, with an estate exclusion of $3.5 million. Gifts made after2012 would have a maximum rate of 45 percent and a return to the $1 million lifetime gift exclusion. The temporary estate, gift, and GST exclusion of $5 million for 2011 and 2012 would not be retained.

Treasury estimates this proposal to reduce revenues by $270.2 billion over 10 years, compared with current law, which otherwise would reinstate pre-2001 estate tax law with a top rate of 55 percent and a $1 million exemption.

Estate tax exemption portability

The Tax Relief of Act of 2010 enacted portability of unused estate tax exemptions between spouses when one spouse dies. The Budget makes portability permanent.

Treasury estimates this proposal to reduce revenue by $3.6 billion over 10 years.

Estate and gift tax valuation discounts

The Budget requires consistency in value for transfer and income tax purposes, modifies the rules on valuation discounts related to intrafamily interest transfers, and requires a minimum 10-year term for grantor retained annuity trusts ("GRATs").

Treasury estimates this proposal to raise $18.1 billion over 10 years.

Duration of GST tax exemption

The Budget limits the duration of the benefit of the GST tax exemption. When the GST tax was enacted, almost all states had rules about how long trusts could last before distributing assets to beneficiaries. Many states have since changed their laws, allowing trusts to continue forever.

The Administration has proposed to effectively terminate the GST exclusion allocated to a trust on the 90th anniversary of its creation. This would be accomplished by a bright-line test. The proposal would be effective for trusts created after the date of enactment and for the portion of pre-existing trusts attributable to additions after that date.

Treasury estimates this proposal to raise $2.9 billion over 10 years.

For a copy of the Treasury Green Book, click on the following link: General Explanation of the Administration's Fiscal Year 2012 Revenue Proposals 02/14/2011

For more information on this WNTS Insight, please contact Larry Campbell at (202) 414-1477 or larry.campbell@us.pwc.com.

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