

Tax Legislative Update

Breaking news from Capitol Hill
from Grant Thornton's National Tax Office

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Tax legislation fills end-of-year congressional agenda

Several major tax bills are set for consideration as the congressional calendar winds down for 2009. Some of these items could slip into 2010, while others are likely to be wrapped up before the end of the year.

Health care reform remains the top priority in Congress and would include many major tax changes. However, several other tax items are also on the move, including:

- estate tax reform;
- extensions of popular tax provisions, such as the research credit, which would be paid for with new international reporting rules and a change in the taxation of carried interest;
- job creation legislation, which could include significant tax provisions; and
- a package of technical corrections for recent tax bills.

Health care reform

The Senate is currently debating its health care bill (H.R. 3950) on the Senate floor. Senate Majority Leader Harry Reid, D-Nev., recently removed a big obstacle by agreeing to replace the so-called public health coverage option with a package of other coverage proposals. Still, the vote to finish work on the package is projected to be very close.

Even if a bill survives a Senate vote, it will still need to be reconciled with separate House legislation (H.R. 3296) that was approved in a very narrow 220 to 215 vote. Senate Democrats are hoping to complete action on their bill before the end of the year, but enactment of a final bill (if it happens) will not come until 2010.

Both the House and Senate bills contain hundreds of billions in tax changes. The House bill's primary revenue offset is a 5.4-percent surtax on income over \$500,000 (\$1 million for joint filers). The top Senate revenue raiser would impose a 40 percent excise tax on most health plans valued at over \$8,500 for singles and \$23,000 for family plans. For a full side-by-side comparison of the tax provisions in the two bills, see

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Estate tax

Congress is racing to finish estate tax legislation before the year ends. If nothing is done, the estate tax will disappear for one year in 2010 before coming back in 2011 with an exemption level of just \$1 million and top rate of 35 percent. There is broad agreement that something must be enacted to prevent this planning nightmare, but there is no consensus on a solution.

The House recently voted 225 to 200 in favor of an estate tax bill (H.R. 4154) that would permanently extend the 2009 exemption of \$3.5 million and top rate of 45 percent. The \$234 billion cost of this legislation was not offset, but the bill did include pay-as-you-go rules that would require future tax cuts to be offset. The bill would not reunify the gift and estate taxes. It also would not index the exemption for inflation or make it fully portable from one spouse to another.

The outlook in the Senate is less clear. Most Senate Democrats favor making 2009 estate tax law permanent, but prefer indexing the exemption for inflation. Sens. Jon Kyl, R-Ariz., and Blanche Lincoln, D-Ark., have proposed a compromise with a \$5 million exemption and top rate of 35 percent, which could also be phased in gradually. The congressional budget only accommodates an extension of 2009 law, so the Lincoln and Kyl compromise may require revenue offsets.

Ultimately, the final package will depend on what gets 60 votes in the Senate. Congressional leaders have quietly floated the possibility of waiting until 2010 to complete legislation, but this could present serious estate planning and political problems — and raise constitutional issues. Other options include the passage of a short-term estate tax bill that would extend 2009 law for just one or two years. A short-term extension could be added to the defense spending bill.

Estate tax reform options for 2011 and beyond		
	Per spouse exemption	Top rate
Current law	\$1 million	55%
House bill (H.R. 4154)	\$3.5 billion	45%
Kyl/Lincoln compromise	\$5 million	35%

Tax extenders

Extensions

The House voted 241 to 181 on Dec. 9, 2009, to approve legislation (H.R. 4213) that would extend popular tax provisions, such as the research credit. The bill includes extensions through 2010 of the full gamut of temporary tax provisions typically called “extenders.” Key tax extenders include:

- Research credit
- Itemized deduction for state and local sales taxes
- 15-year cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements
- Exception under subpart F for active financing income

- Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules
- New markets tax credit.

The one-year extension of the alternative fuel credit in the bill would apply only to specific types of compressed and liquefied gas and would not include forklift propane or black liquor. Black liquor would still qualify for the Section 40 cellulosic biofuels credit, which is currently scheduled to expire at the end of 2013.

The \$31 billion cost of the tax extensions would be paid for by changing the taxation of carried interest and imposing new international reporting rules from the recently unveiled Foreign Account Tax Compliance Act of 2009 (FACTA).

Carried interest

The \$25 billion provision to treat the “carried interest” in a partnership as ordinary income is very similar to the latest carried interest legislation (H.R. 1935) introduced by Rep. Sander Levin, D-Mich. Income and gain received from an “investment services partnership interest” for services would generally be taxed as ordinary income and subject to self-employment tax.

The capital gains rate would continue to apply only to the extent that income represents a reasonable return on capital actually invested in the partnership. The bill would not require the immediate taxation of carried interests at the time they are granted. The change in the treatment of income from an investment services partnership would generally be effective for taxable years ending after Dec. 31, 2009.

Foreign Account Tax Compliance Act of 2009

The bill includes \$7.7 billion in international reporting proposals first introduced as FACTA. The most significant provision would impose a 30 percent withholding tax on income from U.S. financial assets held by foreign financial institutions unless the institutions agree to disclose U.S. accountholders; annually report the account balance, gross receipts and gross withdrawals; and comply with certain other requirements.

Other significant provisions in the bill would:

- require foreign corporations and trusts to provide the name, address and tax identification number of any substantial owners who are U.S. individuals;
- require individuals to report offshore accounts worth over \$50,000 on their tax returns;
- impose a 40 percent penalty for understatements attributable to an undisclosed foreign financial asset; and
- increase the statute of limitations for omissions on a tax return of items over \$5,000 that are attributable to one or more reportable foreign assets.

Outlook

The extenders enjoy bipartisan support and are usually enacted each year by a wide margin. The carried interest and FACTA offsets each also have considerable momentum. However, the Senate is currently preoccupied with health care reform and may not have time to spend on extenders in the near future. The extenders may be paired with a 2009 estate tax bill or could be completed sometime in 2010.

Job creation bill

The high unemployment figures currently plaguing the economic recovery have forced lawmakers to consider another bill to stimulate the economy and create jobs. The president on Dec. 8, 2009, unveiled a package of job creation proposals for Congress. The package was light on details, but did include several tax provisions that would:

- exclude qualified small business stock gains from income;
- extend the \$250,000 limit on Section 179 expensing;
- extend a bonus depreciation provision currently available for qualified investments made in 2008 and 2009;
- create an unspecified job creation tax credit for small businesses;
- extend the 65 percent subsidy for COBRA benefits;
- offer seniors and veterans \$250 rebate checks; and
- offer consumers unspecified rebates for making their homes more energy efficient.

House leaders have announced they may act on a job creation bill before the new year, or wait until 2010. The Senate has even less time for such a bill, so final enactment of any legislation isn't likely until next year. Many of the White House's tax proposals are likely to find support in Congress, though a job creation tax credit is controversial. Many tax writers have complained that job creation credits are difficult to administer and target.

Technical corrections

House tax writers introduced a tax technical corrections bill that makes several technical changes to tax bills enacted over the last three years. Two of the more significant provisions would clarify that:

- seven calendar years (not seven taxable years) in the 10-year recognition period must elapse before any taxable year beginning in 2009 or 2010 for an S corporation to be eligible for the built-in gains tax relief under the American Recovery and Reinvestment Act of 2009; and
- assets that qualify for the 15-year recovery period for leasehold improvement property will qualify for bonus depreciation even if they also qualify as qualified restaurant property or qualified retail improvement property (which cannot use bonus depreciation).

Technical corrections are usually noncontroversial and are often added to other legislation. It will be possible for this legislation to be carried on the next tax bill that is headed for enactment.

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