

# Tax Legislative Update

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

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## Obama unveils new tax proposals in 2011 budget

President Obama introduced several new tax increases and incentives in a 2011 budget proposal that includes over a trillion dollars in tax changes. Most of the tax proposals are unchanged from those in last year's budget proposal, but several important provisions were added that involve international taxes, worker classification, job creation and energy incentives.

Some of the biggest changes came in the \$122 billion international reform package, where \$88 billion was trimmed from last year's \$210 billion package. Most significantly, a proposal to reform the "check-the-box" rules is not included in this year's budget, which also softens a provision meant to limit the benefits of deferring foreign income. One new international proposal would tax "excess returns" associated with transfers of intangibles offshore.

The president added several "economic recovery" tax proposals to the handful of proposed tax incentives. The budget proposes extending bonus depreciation rules through 2010, increasing Section 179 expensing limits and creating a new temporary job creation tax credit. The president also still supports extending the 2001 and 2003 tax cuts for individuals with income under \$200,000 (single) and \$250,000 (married).

But like last year, the bulk of the tax package consists of proposals that will increase taxes, raising revenue by an estimated \$1.4 trillion with:

- \$122 billion from changes in international taxation;
- \$39 billion for repealing tax incentives for fossil fuels like oil, gas and coal;
- \$307 billion general revenue raisers such as LIFO repeal and carried interest; and
- \$969 billion from a rollback of the Bush tax cuts for individuals earning more than \$200,000 (single) or 250,000 (married).

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Last year, the revenue from many of these offsets was dedicated for health care reform. Healthcare reform now receives a separate \$150 billion allowance in another part of the budget, while most of the tax offsets are retained as general tax proposals. The president also abandoned climate change legislation as a revenue source for permanently extending the Making Work Pay Credit. This year's budget would extend the credit for only one year and instead calls for revenue neutral energy and climate change legislation.

The president for the first time proposed tightening the rules for classifying workers as employees or independent contractors — an issue he championed while in the Senate. The budget expands the proposed repeal of oil and gas incentives to cover many coal-related incentives. It also includes the administration's recent financial industry tax proposal.

It's important to remember that many of the tax proposals will remain controversial, and there is no guarantee they will be enacted. A presidential budget proposal is important, but it is far from the last word. Some of the tax proposals will be examined carefully by Congress, while others may not be considered this year, or ever.

#### Business tax incentives

**QSB stock (\$8 billion)** – The budget proposes to increase the exclusion for qualified small business (QSB) stock to 100 percent and eliminate the alternative minimum tax (AMT) adjustment. The stimulus bill enacted in February 2009 increased the 50 percent exclusion of gain from QSB stock to 75 percent for stock issued between Feb. 17, 2009, and the end of 2010.

**Research credit (\$82.6 billion)** – The budget again proposes to make the existing research credit permanent.

**Extenders (\$46.7 billion)** – The budget proposes extending through 2011 a number of tax provisions known as “extenders” that expired at the end of 2009, including:

- subpart F “active financing” and “look through” exceptions;
- new markets tax credits and incentives for empowerment and community renewal zones; and
- special 15-year recovery periods for qualified leasehold improvements and restaurant property (the 15-year recovery period for qualified retail improvements, which also expired at the end of 2009, is not mentioned).

**Bonus depreciation (\$20 billion)** – The budget supports an extension of bonus depreciation rules for property placed in service in 2010. The election to accelerate unused AMT and research credits in lieu of bonus depreciation would also be extended.

**Section 179 expensing (\$753 million)** – The budget proposes extending through 2010 the \$250,000 limit for small business expensing under Section 179 and the phaseout

threshold of \$800,000. The budget would make permanent (after 2010) the 2006 limit of \$125,000 and the phaseout threshold of \$500,000, indexed to inflation.

**Section 48C advanced energy credit (\$3.7 billion)** – The budget proposes allocating an additional \$5 billion for the 30 percent Section 48C advanced energy product credit. The 2009 stimulus bill that created the credit only allocated \$2.3 billion.

**Housing tax credit grant extension (\$2.2 billion)** – This proposal would allow states to elect cash assistance in lieu of low-income housing tax credits for 2010.

**Job creation credit (\$33 billion)** – The Treasury budget explanation does not describe the job creation credit, but the budget itself includes a line item for job creation legislation that encompasses the president’s recent job credit proposal. The administration proposes a credit of \$5,000 for each net new job created in 2010 and a credit equal to 6.2 percent of aggregate wage increases in excess of inflation. The total benefit of both would be capped at \$500,000 per employer.

**Employer-provided cell phones (\$2.8 billion)** – This new proposal would remove the tax consequences and substantiation requirements for employer-provided cell phones. Currently, employers are denied a deduction for Section 280F “listed property” such as cell phones unless business purpose and use are documented, and employees must include the value of any personal usage of their cell phone in income.

**New markets tax credit (\$3.4 billion)** – The administration proposes extending the new markets tax credit for 2010 and 2011 with an allocation amount of \$5 billion each year.

**Retirement plan enhancements (\$10.4 billion)** – The budget proposes doubling the \$500 three-year “startup costs” tax credit for small employers who adopt a new qualified retirement, SEP or SIMPLE plan. The budget would also require businesses with over 10 employees to offer automatic opt-out individual retirement accounts (IRAs) to employees. Employers could claim a two-year tax credit for \$25 per enrolled employee in the new automatic IRAs, up to a maximum credit of \$250.

#### General business revenue raisers

**LIFO repeal (\$59.1 billion)** – The budget proposes the repeal of the last-in, first-out (LIFO) method of accounting. Last year’s budget would have allowed taxpayers to include any LIFO reserve in income ratably over eight years, but this year’s version extends that period to 10 years.

**LCM repeal (\$7.5 billion)** – The administration retained a proposal from last year that would prohibit the use of lower-of-cost-or-market (LCM) and subnormal goods methods. Any Section 481(a) adjustment resulting from an accounting method change away from these methods would be included in income ratably over a four-year period beginning with the year of change.

**Carried interest (\$24 billion)** – The administration again included a broad proposal to change the taxation of “carried interest” in a partnership. Income and gain attributable to a “services partnership interest” would be taxed as ordinary income and subject to self-employment tax. A services partnership interest would be any interest in a partnership held by a person who provides services to a partnership that is not attributable to “invested capital” — invested capital is money or property contributed to the partnership.

The proposal is largely unchanged from last year and is significantly broader than the carried interest provision passed by the House in 2009 (H.R. 4213). The House version, while still broad, does not apply to all services provided to a partnership or all types of partnerships. It instead covers specific investment services, defined as: advising as to the advisability of investing in, purchasing or selling specified assets; managing, acquiring or disposing of any specified asset; arranging financing with respect to acquiring specified assets; and any activity in support of any of the foregoing services. It also applies only to certain categories of partnerships.

**Economic substance doctrine (\$4.2 billion)** – The administration continues to support codifying the economic substance doctrine so that a transaction would be respected for tax purposes only if it changes the taxpayer’s economic position in a meaningful way **and** the taxpayer has a substantial economic purpose for the transaction.

Under the proposal, a transaction would not be considered to have a substantial economic purpose solely by reason of profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the net federal tax benefits arising from the transaction. A 30 percent penalty (20 percent if there is adequate disclosure) would be imposed on any understatement of tax that is attributable to a transaction lacking economic substance. The penalty could be abated, but only in the same proportion as the abatement of the under-lying tax liability. Interest attributable to an underpayment attributable to a transaction lacking economic substance would not be deductible.

**Worker classification (\$7.3 billion)** – This new proposal would make several changes to tighten the rules for classifying workers as employees or independent contractors. The administration would direct the IRS to issue new guidance on worker classification that included narrowly defined safe harbors and rebuttable presumptions. The IRS would be able to reclassify misclassified workers whose reclassification is prohibited under current law. Service recipients would be required to disclose to independent contractors the tax and benefit implications of their classification, and independent contractors could request withholding on their payments.

**Black liquor (\$24 billion)** – The budget proposes changing the requirements for the \$1.01 per gallon cellulosic biofuels credit to exclude the “black liquor” byproduct of paper processing.

**Extension of FUTA (\$14.2 billion)** – The budget proposes making the federal 0.2 percent unemployment surtax permanent.

**Superfund taxes (\$18.9 billion)** – The budget would reinstate superfund taxes, including superfund excise taxes and the superfund environment income tax of 0.12 percent of corporate income subject to the AMT.

#### Financial industry revenue raisers

**Financial institution tax (\$90 billion)** – The budget includes the president’s recent proposal to impose \$90 billion in taxes on the liabilities of financial institutions with over \$50 billion in assets. Financial institutions covered by the tax would include insured depository institutions, bank holding companies, thrift holding companies, insurance companies, companies that own insured depository institutions and securities broker-dealers. The tax would be equal to 0.15 percent of liabilities, which would be defined as assets minus Tier 1 capital, FDIC deposits and any insurance policy reserves.

**Forward sales of corporate stock (\$295 billion)** – A corporation that sells its stock forward (agrees to issue the stock in the future) would be required to recognize imputed interest income on the deferred payment.

**Dealers of equity options and commodities (\$2.6 billion)** – Dealers in commodities, commodities derivatives, securities or equity options would be required to treat income from their dealer transactions as ordinary income. The ability to treat 60 percent of gain as long-term gain would be repealed.

**“Boot-within-the gain” repeal (\$788 million)** – The proposal would repeal the “boot-within-gain” limitation under Section 356 for reorganizations in which the shareholder’s exchange has the effect of the distribution of a dividend, as determined under Section 356(a)(2). A version of this proposal was included in this last year’s budget, but would have applied only in cases where the acquiring corporation was foreign.

#### Insurance revenue raisers

**COLI (\$7.8 billion)** – The budget includes a proposal that would restrict the use of company-owned life insurance (COLI) by repealing the exception from the pro rata interest rules for employees, officers and directors that are not also 20 percent shareholders.

**Insurance institutions and products (\$6.6 billion)** – The budget includes proposals to expand the reporting of transactions in large life insurance contracts, modify the dividends received deduction for life insurance company separate accounts and permit partial annuitization of nonqualified annuity contracts.

### Fossil fuel revenue raisers

**Oil and gas (\$36.5 billion)** – The administration did not re-propose an excise tax on oil and gas produced on the outer continental shelf, but otherwise included all of last year's raisers applicable to the oil and gas industry:

- Modify Section 199 (the domestic production activities deduction) to exclude revenues from the sale or disposition of oil, natural gas or a primary product thereof
- Repeal enhanced oil recovery credit
- Repeal marginal well tax credit
- Repeal percentage depletion for oil and natural gas and require cost depletion to be used
- Require intangible drilling costs to be capitalized and recovered as depreciable or depletable property
- Require tertiary injectant costs to be capitalized and recovered as depletable property
- Repeal passive loss exception for working interests in oil and natural gas properties
- Increase geological and geophysical amortization period from two to seven years for independent producers

**Coal and minerals (\$2.3 billion)** – The administration this year expanded its proposals to repeal incentives for fossil fuels to include coal and other hard minerals such as lignite and oil shale. The budget proposes to do the following:

- Modify Section 199 (the domestic production activities deduction) to exclude revenues from the sale or disposition of coal, lignite, oil shale, other hard mineral fossil fuels and products thereof
- Require exploration and development costs for coal, lignite, oil shale and other hard mineral fossil fuels to be capitalized as depreciable or depletable property
- Repeal percentage depletion for coal, lignite, oil shale and other hard mineral fossil fuels and require cost depletion to be used
- Require coal and lignite royalties to be taxed as ordinary income instead of capital gains

### International revenue raisers

**Limiting deferral (\$25.6 billion)** – This proposal was included in last year's budget, but is limited this year to interest expense. Companies would be required to defer any interest deductions allocated to foreign-source income to the extent the foreign-source income associated with the interest expense is not currently subject to U.S. tax. This provision would effectively limit the deferral regime by forcing U.S. companies to repatriate income to use interest deductions.

**Reforming the foreign tax credit (\$59.4 billion)** – The administration re-proposed two major changes to foreign tax credit rules. First, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis based on the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with which the U.S.

taxpayer could claim a deemed paid foreign tax credit (including lower tier subsidiaries described in Section 902(b)). Second, a matching rule would be adopted to prevent the separation of creditable foreign taxes from the associated foreign income.

**Intangible transfers offshore (\$15.5 billion)** – Under this new proposal, if a U.S. person transferred an intangible to a related controlled foreign corporation subject to “a low foreign effective tax rate” and there is evidence of “excessive income shifting,” then the excessive return would be treated as subpart F income in a separate foreign tax credit limitation basket.

**Intangible property guidance (\$1.2 billion)** – This proposal would clarify the definition of intangible property for purposes of Sections 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal would also clarify that in a transfer of multiple intangibles, the IRS could value the intangible properties on an aggregate basis if it achieves a more reliable result. Intangible property would have to be valued at its highest and best use.

**Reinsurance premiums (\$519 million)** – Under this new proposal, a U.S. insurance company would be denied a deduction in certain instances for certain reinsurance premiums paid to affiliated foreign reinsurance companies with respect to U.S. risks insured by the insurance company or its U.S. affiliates.

**Limit earnings stripping by expatriated entities (\$3.6 billion)** – The budget proposes revising Section 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons.

**Repeal 80/20 company exception (\$1.1 billion)** – The budget proposes to repeal an exception to the withholding rules for dividends and interest paid to a foreign person that currently applies to domestic corporations if at least 80 percent of their gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business.

**Dividend withholding tax avoidance (\$1.2 billion)** – Income earned by foreign persons with respect to equity swaps that reference U.S. equities would be treated as U.S.-source to the extent that the income is attributable to dividends paid by a domestic corporation — with exceptions for certain swaps.

**Dual capacity taxpayers (\$8.5 billion)** – The proposal would treat a foreign levy that would otherwise qualify as an income tax, or in lieu of tax as a creditable tax, only if the foreign country generally imposes an income tax, as well as make other changes.

**Offshore reporting (\$5.4 billion)** – The administration re-proposed without significant changes a long list of proposals to tighten offshore financial reporting rules and penalties, including proposals to do the following:

- Modify the QI regime, including requiring greater reporting by QIs regarding U.S. accounts
- Provide several special rules relating to non-QIs
- Require reporting of certain transfers of money or property to foreign financial accounts
- Require disclosure of FBAR accounts to be filed with tax returns
- Require third-party information reporting regarding certain transfers of assets to foreign financial accounts and the establishment of foreign financial accounts
- Create certain negative presumptions relating to FBARs
- Create certain negative presumptions relating to withholding on fixed or determinable annual or periodical (FDAP) income payments to certain foreign entities
- Extend the statute of limitations for certain reportable cross-border transactions and foreign entities
- Impose double accuracy-related penalties on certain understatements involving undisclosed foreign accounts
- Change the foreign trust reporting penalty

#### IRS administrative revenue raisers

**IRS administrative procedures (\$2.5 billion)** – The budget proposes raising \$2.5 billion in new revenue through administrative changes and expansions in the IRS's reach, including proposals to do the following:

- Allow the IRS to issue levies before a Collection Due Process hearing for federal employment tax liabilities of federal contractors identified by the automated Federal Payment Levy Program
- Expand the ability of the IRS to levy 100 percent of federal contractor payments to include payments for the sale or lease of real estate and other types of property not considered goods or services
- Allow offset of federal refunds to collect state income tax regardless of where the delinquent taxpayer resides
- Deny any deduction for punitive damages for a claim or settlement and include in income any damages paid by insurance to the insured person
- Set standards for holding employee leasing companies jointly and severally liable or solely liable for federal employment taxes
- Allow the IRS to collect court-ordered restitution immediately in a criminal tax case without issuing a statutory notice of deficiency
- Eliminate the requirements that an initial offer-in-compromise include a nonrefundable portion of the taxpayer's offer
- Expand IRS access to the National Directory of New Hires data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for non-compliant taxpayers and identification of levy sources

- Make certain cases of repeated willful failure to file a tax return a felony instead of a misdemeanor
- Treat Indian tribal governments that impose alcohol, tobacco, excise or income or wage taxes as states for purposes of information sharing
- Create an exception to the three-year statute of limitations for assessment of federal tax liability resulting from adjustments to state or local tax liability

#### Information reporting revenue raisers

**Form 1099 for corporate payments (\$9.2 billion)** – The exception from Form 1099 reporting rules for payments to corporations would be removed so that all aggregate payments over \$600 in a year to a corporation would require the filing of an information return.

**Rental expense reporting (\$3.1 billion)** – This new proposal would require taxpayers with rental income to report payments of \$600 or more made to a service provider to the IRS and the service provider on an information return such as Form 1099.

**Contractor withholding (\$704 million)** – Contractors would have to furnish valid TINs to any business that they receive at least \$600 of payments from in a year or face withholding.

**Government payment reporting (\$388 million)** – The IRS would be authorized to issue regulations to require information reporting on payments by federal, state and local governments to government contractors for property or services.

**Life insurance separate account reporting (\$58 million)** – Life insurance companies would be required to report policyholder information to the IRS for each contract with a cash value partially or wholly invested in a private separate account for any portion of the taxable year.

#### Penalty revenue raisers

**Information return penalties (\$9 million)** – Information return penalties would generally be doubled for each return and the maximum yearly penalty would increase by three times or more in most cases.

**Bad check penalty (\$27 million)** – The penalty for submitting bad checks or money orders to the IRS would be expanded to cover all commercially acceptable instruments of payment that are not duly paid.

**Electronic filing requirements (no revenue effect)** – All corporations and partnerships that are required to file Schedule M-3 would be required to file electronically. Exceptions would be made for entities for whom electronic filing would create an undue financial burden. The budget would create a new \$25,000 penalty for corporations (\$5,000 for tax-exempt organizations) that do not comply with electronic filing requirements.

### Individual tax provisions

**Tax cuts for income under \$200,000 and \$250,000** – The budget assumes the extension of the Bush tax cuts in 2001 and 2003 for all taxpayers under the income threshold. This includes the following:

- \$1,000 child credit
- Marriage penalty relief
- 15 percent rate on capital gains and dividends
- Brackets up to the 28 percent bracket, including the expanded 10 percent bracket

**Tax cuts for income over \$200,000 or \$250,000 (\$965.9 billion)** – For singles with over \$200,000 and joint filers with over \$250,000 in modified AGI, the budget proposes a number of significant tax increases, including proposals to do the following:

- Reinstatement of the pre-Bush top two marginal rates of 36 percent and 39.6 percent
- Imposition of a 20 percent rate on capital gains and dividends
- Reinstatement of the personal exemption phaseout (PEP) and three percent limitation on itemized deductions (Pease) of the pre-Bush tax cut era
- Further limit itemized deductions by capping the applicable tax rate at 28 percent

**Stimulus bill tax provisions (\$157.5 billion)** – The budget proposes making permanent or temporarily extending several of the tax provisions from last year's stimulus bill:

- The higher EITC credits for low-income joint filers and taxpayers with three or more children would be made permanent (advanceable EITC would be repealed).
- The expansion of the Hope credit for qualified tuition into the American Opportunity Credit would be made permanent (credit amounts and phaseout thresholds would also be indexed for inflation).
- The Making Work Pay Credit (\$400 for singles or \$800 for joint filers subject to income limits) would be extended for one year to apply in 2011.
- The \$250 Economic Recovery Payment for Social Security recipients and certain government retirees not eligible for the Making Work Pay Credit would be extended for one year to apply in 2010.
- The 65 percent 15-month COBRA subsidy for certain employees that are involuntarily terminated before Feb. 28, 2010, would be extended to provide assistance for up to 12 months for those who are involuntarily terminated during the remainder of 2010.

**Child care credit (\$12.6 billion)** – The budget proposes increasing the AGI limit at which the credit begins to phase out from \$15,000 to \$85,000. The budget also accommodates a permanent extension of the increase in refundability that was passed as part of the 2009 stimulus bill.

**Expanded saver's credit (\$29.8 billion)** – The proposal would create a refundable credit that provides a 50 percent match on the first \$1,000 of savings for families (\$500 for singles). The credit would phase out for joint filers with AGI between \$65,000 and \$85,000 and for singles with AGI between \$32,500 and \$42,500.

**Alternative minimum tax (\$659 billion)** – The budget proposes to patch perpetually (but not repeal) the individual AMT by indexing the 2009 AMT parameters (including tax brackets, exemption amounts and the phaseout triggers) for inflation.

### Estate tax changes

**Exemption and rate (\$262 billion)** – The budget assumes the retroactive and permanent extension of the estate, gift and generation-skipping tax rules applicable in 2009, including the tax rates (45 percent) and exemption amounts (\$3.5 million for estates).

**Valuation discounts (\$18.7 billion)** – The administration proposes creating an additional category of “disregarded restrictions” under Section 2704 that would be ignored in valuing an interest in a family partnership. In certain circumstances, this would curb the discounts taxpayers can achieve for transfer tax purposes by putting assets in a family limited partnership. Broad regulatory authority would be granted to the IRS to determine which restrictions should be disregarded, as well as to create safe harbors to permit taxpayers to avoid these restrictions.

**Minimum GRAT term (\$3 billion)** – The administration has again proposed a new minimum term requirement of 10 years for grantor retained annuity trusts (GRATs). This would make a GRAT a riskier planning technique because the transfer tax benefits of GRATs are typically achieved when the grantor outlives the GRAT term. In addition, this year's proposal would also require the remainder interest of a GRAT to have a value other than zero.

**Consistency in valuations (\$2.1 billion)** – This proposal would limit the basis of inherited property to the value the property is assigned for estate tax purposes (subject to subsequent adjustments). The executor of an estate would be required to report the valuations used in filing the estate tax return.

### A note regarding revenue estimates:

All estimates are for the 10-year budget period from 2011 through 2020. The revenue estimates in this paper follow the administration's approach of not scoring AMT indexing for inflation or the extension of the 2001 and 2003 tax cuts for individuals, including the expansion of the child care and earned income credits. If those items were scored against current law, they would be estimated to result in a revenue decrease of \$3.7 trillion, making the total estimate for all tax proposals (other than the proposed new jobs credit) a revenue loss of \$2.6 trillion.

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