General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals

Department of the Treasury
February 2012

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[1] The Administration's policy proposals reflect changes from a tax baseline that modifies the Budget Enforcement Act baseline by permanently extending alternative minimum tax relief, freezing the estate tax at 2012 levels, and making permanent the tax cuts enacted in 2001 and 2003. These baseline changes are described in the adjustments to the Budget Enforcement Act Baseline section, below.

TEMPORARY TAX RELIEF TO CREATE JOBS AND JUMPSTART GROWTH

EXTEND TEMPORARY REDUCTION IN THE SOCIAL SECURITY PAYROLL TAX RATE FOR EMPLOYEES AND SELF-EMPLOYED INDIVIDUALS

Current Law

Most wages and salaries are subject to Social Security and Medicare taxes under the Federal Insurance Contributions Act (FICA). Earnings from self-employment are subject to Social Security and Medicare taxes under the Self Employment Contributions Act (SECA).

The FICA tax is imposed to fund two different benefit programs: (1) the old-age, survivor and disability insurance program ("OASDI"), which funds the Social Security program that provides monthly retirement, disability, and survivor benefits; and (2) Medicare hospital insurance ("HI"). Generally, the OASDI tax rate of 12.4 percent applies to taxable wages and salaries up to the OASDI wage base ($106,800 for 2011 and $110,100 for 2012), and the HI tax of 2.9 percent applies to all taxable wages and salaries. Generally, one-half of both OASDI and HI taxes are paid by the employer and the other half are paid by the employee through mandatory withholding. Earnings from self-employment are also subject to Social Security and Medicare taxes at the same total tax rates, and one-half of the amount of SECA tax (that is, the amount equivalent to the employer portion of FICA) is deductible for income tax purposes.

For the first $106,800 of taxable wages and salaries received during 2011 and essentially the first $18,350 of taxable wages and salaries received during the first two months of 2012, the Social Security tax on employees was reduced by 2.0 percentage points, from 6.2 percent to 4.2 percent, and the Social Security tax on the self-employed was similarly reduced from 12.4 percent to 10.4 percent. The Social Security Trust Fund was held harmless and received transfers from the General Fund equal to the reduction in payroll taxes attributable to these reductions in the payroll tax rate.

Reasons for Change

The temporary reduction in Social Security tax provides relatively large benefits to workers who have been hardest hit by the recession and are most likely to spend their tax cut, stimulating the economy and creating jobs. Payroll tax cuts are particularly effective because they are delivered immediately in the worker's paycheck, regardless of whether the worker has a current income tax liability.

Extending this reduction in payroll taxes would provide continued financial assistance to middle-class families and encourage additional job creation.

Proposal

The Administration proposes to extend the 2.0 percentage point reduction in the Social Security tax on employees to the first $110,100 of taxable wages and salaries received during 2012. Similarly, the Administration proposes to extend the 2.0 percentage point reduction in the Social Security tax on the self-employed to the first $110,100 of taxable self-employment earnings received during 2012. The Social Security Trust Fund will be held harmless and receive transfers from the General Fund equal to the reduction in payroll taxes attributable to these reductions in the payroll tax rate.

The proposal would be effective upon the date of enactment.

EXTEND 100 PERCENT FIRST-YEAR DEPRECIATION DEDUCTION FOR ONE ADDITIONAL YEAR

Current Law

An additional first-year depreciation deduction is temporarily allowed for qualified property placed in service before January 1, 2013. The deduction equals 50 percent of the cost of qualified property placed in service during the taxable year, and is allowed as a depreciation deduction for both regular tax and alternative minimum tax purposes. The property's depreciable basis is adjusted to reflect this additional deduction. Taxpayers may elect out of this additional depreciation deduction for any class of property for any taxable year. The additional first-year deduction equaled 100 percent of the cost of qualified property acquired after September 8, 2010 and before January 1, 2012, and placed in service prior to January 1, 2012.

Qualified property includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property. It excludes property that is required to be depreciated under the alternative depreciation system. The original use of the property must commence with the taxpayer, and the taxpayer must purchase (or begin the manufacture or construction of) the property after December 31, 2007 and before January 1, 2013 (but only if no written binding contract for the acquisition was in effect before January 1, 2008). The property must be placed in service before January 1, 2013. An extension by one year of the placed-in-service date is allowed for certain property having longer production periods, but only the portion of the basis that is properly attributable to costs incurred prior to January 1, 2013 may be taken into account. Certain aircraft not used in providing transportation services are also granted a one-year extension of the placed-in-service deadline. Special rules apply to syndications, sale-leasebacks, and transfers to related parties of qualified property. The dollar limitation on the first-year depreciation allowance of qualifying passenger automobiles is increased by $8,000.

Corporations otherwise eligible for additional first-year depreciation may elect to claim additional alternative minimum tax credits in lieu of claiming the additional depreciation for "eligible qualified property." Such property includes otherwise qualified property that was acquired after March 31, 2008, and only adjusted basis attributable to its manufacture, construction, or production after that date and before January 1, 2010, or after December 31,2010, and before January 1, 2013 is taken into account. Depreciation for such property must be computed using the straight-line method if the corporation elects this provision.

Reasons for Change

By accelerating in time the recovery of investment costs, additional first-year deductions for new investment lower the after-tax costs of capital purchases. This encourages new investment and promotes economic recovery.

Proposal

The proposal would extend the 100-percent additional first-year depreciation deduction for one additional year. Thus, qualified property acquired and placed in service through 2012 (2013 for property eligible for a one-year extension of the placed-in-service date) could be fully expensed. Taxpayers could elect not to expense any class of their qualified property and instead depreciate that property without any additional first-year depreciation deduction.

The proposal would be effective for qualified property placed in service after December 31, 2011.

PROVIDE A TEMPORARY 10-PERCENT TAX CREDIT FOR NEW JOBS AND WAGE INCREASES

Current Law

Under current law, there is no generally available income tax credit for job creation or increasing employees' wages.

Reasons for Change

Although the economy is recovering from a severe economic recession and the private sector has increased employment, a tax credit designed to stimulate job creation and wage increases could help put more Americans back to work, provide tax relief targeted at America's small businesses, and strengthen the foundation of the economic recovery.

Proposal

Under the proposal, qualified employers would be provided a tax credit for increases in wage expense, whether driven by new hires, increased wages, or both. The credit would be equal to 10 percent of the increase in the employer's 2012 eligible wages over the prior year (2011). Eligible wages are the employer's Old Age Survivors and Disability Insurance (OASDI) wages. The wage base for determining the maximum amount of OASDI wages per employee is $106,800 for 2011 and $110,100 for 2012. The maximum amount of the increase in eligible wages would be $5 million per employer, for a maximum credit of $500,000, to focus the benefit on small businesses. For employers with no OASDI wages in 2011, eligible wages for 2011 would be 80 percent of their OASDI wage base for 2012. The credit would generally be considered a general business credit. A similar credit would be provided for qualified tax-exempt employers. The Secretary may prescribe rules with respect to eligible wages.

The credit would only apply with respect to the wages of employees performing services in a trade or business of a qualified employer or, in the case of a qualified employer exempt from tax under section 501(a), in furtherance of the activities related to the purpose or function constituting the basis of the employer's exemption under section 501. Self-employment income would not be considered eligible wages.

A qualified employer means any employer other than the United States, any State or possession of the United States, or any political subdivision thereof, or any instrumentality of the foregoing. A qualified employer also includes any employer that is a public institution of higher education (as defined in section 101 of the Higher Education Act of 1965).

For purposes of determining the $5 million limit on the maximum amount of OASDI wages available for the credit, all employees of all corporations that are members of the same controlled group (using the 80-percent ownership test for filing a consolidated return) would be treated as employed by a single employer. For partnerships, proprietorships, etc., all employees under common control would be treated as employed by a single employer. The Secretary may prescribe rules with respect to predecessor and successor employers.

The credit also would be available for increases in earnings subject to tier 1 Railroad Retirement taxes subject to OASDI rates (section 3111(a)).

Similar benefits would be extended to non-mirror code possessions (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

The proposal would be effective for wages paid during the one-year period beginning on January 1, 2012.

PROVIDE ADDITIONAL TAX CREDITS FOR INVESTMENT IN QUALIFIED PROPERTY USED IN A QUALIFYING ADVANCED ENERGY MANUFACTURING PROJECT

Current Law

A 30-percent tax credit is provided for investments in eligible property used in a qualifying advanced energy project. A qualifying advanced energy project is a project that re-equips, expands, or establishes a manufacturing facility for the production of: (1) property designed to produce energy from renewable resources; (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric vehicles; (3) electric grids to support the transmission, including storage, of intermittent sources of renewable energy; (4) property designed to capture and sequester carbon dioxide emissions; (5) property designed to refine or blend renewable fuels or to produce energy conservation technologies; (6) electric drive motor vehicles that qualify for tax credits or components designed for use with such vehicles; and (7) other advanced energy property designed to reduce greenhouse gas emissions.

Eligible property is property: (1) that is necessary for the production of the property listed above; (2) that is tangible personal property or other tangible property (not including a building and its structural components) that is used as an integral part of a qualifying facility; and (3) with respect to which depreciation (or amortization in lieu of depreciation) is allowable.

Under the American Recovery and Reinvestment Act of 2009 (ARRA), total credits were limited to $2.3 billion, and the Treasury Department, in consultation with the Department of Energy, was required to establish a program to consider and award certifications for qualified investments eligible for credits within 180 days of the date of enactment of ARRA. Credits may be allocated only to projects where there is a reasonable expectation of commercial viability. In addition, consideration must be given to which projects: (1) will provide the greatest domestic job creation; (2) will have the greatest net impact in avoiding or reducing air pollutants or greenhouse gas emissions; (3) have the greatest potential for technological innovation and commercial deployment; (4) have the lowest levelized cost of generated or stored energy, or of measured reduction in energy consumption or greenhouse gas emission; and (5) have the shortest completion time. Guidance under current law requires taxpayers to apply for the credit with respect to their entire qualified investment in a project.

Applications for certification under the program may be made only during the two-year period beginning on the date the program is established. An applicant that is allocated credits must provide evidence that the requirements of the certification have been met within one year of the date of acceptance of the application and must place the property in service within three years from the date of the issuance of the certification.

Reasons for Change

The $2.3 billion cap on the credit has resulted in the funding of less than one-third of the technically acceptable applications that have been received. Rather than turning down worthy projects that could be deployed quickly to create jobs and support economic activity, the program –

which has proven successful in leveraging private investment in building and equipping factories that manufacture clean energy products in America – should be expanded. An additional $5 billion in credits would support nearly $17 billion in total capital investment, creating tens of thousands of new construction and manufacturing jobs. Because there is already an existing pipeline of worthy projects and substantial interest in this area, the additional credit can be deployed quickly to create jobs and support economic activity.

Proposal

The proposal would authorize an additional $5 billion of credits for investments in eligible property used in a qualifying advanced energy manufacturing project. Taxpayers would be able to apply for a credit with respect to part or all of their qualified investment. If a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government would be taken into account in determining whether to allocate credits to the project.

Applications for the additional credits would be made during the two-year period beginning on the date on which the additional authorization is enacted. As under current law, applicants that are allocated the additional credits must provide evidence that the requirements of the certification have been met within one year of the date of acceptance of the application and must place the property in service within three years from the date of the issuance of the certification.

The change would be effective on the date of enactment.

PROVIDE TAX CREDIT FOR ENERGY-EFFICIENT COMMERCIAL BUILDING PROPERTY EXPENDITURES IN PLACE OF EXISTING TAX DEDUCTION

Current Law

Taxpayers are allowed to deduct expenditures for energy efficient commercial building property. Energy efficient commercial building property is defined as property that (1) is installed on or in any building that is located in the United States and is within the scope of Standard 90.1-2001, (2) is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, (3) is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building that meets the minimum requirements of Standard 90.1-2001, and (4) with respect to which depreciation (or amortization in lieu of depreciation) is allowable. Standard 90.1-2001, as referred to here, is Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (ASHRAE/IESNA) as in effect on April 2, 2003 – a nationally accepted building energy code that has been adopted by local and state jurisdictions throughout the United States. The deduction with respect to a building is limited to $1.80 per square foot.

In the case of a building that does not achieve a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system (interior lighting; heating, cooling, ventilation, and hot water; and building envelope) that meets the system-specific energy-savings target prescribed by the Secretary of the Treasury. The applicable system-specific savings targets are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system-specific target. The maximum allowable deduction for each of the separate systems is $0.60 per square foot.

The deduction is allowed in the year in which the property is placed in service. If the energy efficient commercial building property expenditures are made by a public entity, the deduction may be allocated under regulations to the person primarily responsible for designing the property. The deduction applies to property placed in service on or before December 31, 2013.

Reasons for Change

The President has called for a new Better Buildings Initiative that would over 10 years reduce energy usage in commercial buildings by 20 percent. This initiative would catalyze private sector investment in upgrading the efficiency of commercial buildings. Changing the current tax deduction for energy efficient commercial building property to a tax credit and allowing a partial credit for achieving less stringent efficiency standards would encourage private sector investments in energy efficiency improvements. In addition, allowing a credit based on prescriptive efficiency standards would reduce the complexity of the current standards, which require whole-building auditing, modeling, and simulation.

Proposal

The proposal would replace the existing deduction for energy efficient commercial building property with a tax credit equal to the cost of property that is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 20 percent or more in comparison to a reference building which meets the minimum requirements of ASHRAE/IESNA Standard 90.1-2004, as in effect on the date of enactment.

The credit with respect to a building would be limited to $0.60 per square foot in the case of energy efficient commercial building property designed to reduce the total annual energy and power costs by at least 20 percent but less than 30 percent, to $0.90 per square foot for qualifying property designed to reduce the total annual energy and power costs by at least 30 percent but less than 50 percent, and to $1.80 per square foot for qualifying property designed to reduce the total annual energy and power costs by 50 percent or more.

In addition, the proposal would treat property as meeting the 20-, 30-, and 50-percent energy savings requirement if specified prescriptive standards are satisfied. Prescriptive standards would be based on building types (as specified by Standard 90.1-2004) and climate zones (as specified by Standard 90.1-2004).

Special rules would be provided that would allow the credit to benefit a REIT or its shareholders.

The tax credit would be available for property placed in service during calendar year 2013.

REFORM AND EXTEND BUILD AMERICA BONDS

Current Law

Build America Bonds are a new lower-cost borrowing tool for State and local governments that were enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA). Traditional tax-exempt bonds provide for lower borrowing costs for State and local governments indirectly through a Federal tax exemption to investors for the interest income received on the bonds. By comparison, Build America Bonds are conventional taxable bonds issued by State and local governments in which the Federal Government makes direct payments to State and local governmental issuers to facilitate lower borrowing costs. In particular, for Build America Bonds, the Treasury Department makes direct payments to State and local governmental issuers (called "refundable tax credits") to subsidize a portion of their borrowing costs in an amount equal to 35 percent of the coupon interest on the bonds. Issuance of Build America Bonds is limited to original financing for public capital projects for which issuers otherwise could use tax-exempt "governmental bonds" (as contrasted with "private activity bonds" which benefit private entities.) ARRA authorized the issuance of Build America Bonds in 2009 and 2010 without volume limitation and authority to issue these bonds expired at the end of 2010. Build America Bonds are an optional alternative to traditional tax-exempt bonds.

Tax-exempt bonds have broader program parameters than Build America Bonds, and may be used in the following ways: (1) original financing for public capital projects, as with Build America Bonds; (2) "current refundings" to refinance prior governmental bonds for interest cost savings where the prior bonds are repaid promptly within ninety days of issuance of the refunding bonds (as well as one "advance refunding," in which two sets of bonds for the same governmental purpose may remain outstanding concurrently for a period of time longer than ninety days); (3) short-term "working capital" financings for governmental operating expenses for seasonal cash flow deficits (as well as certain longer-term deficit financings which have strict arbitrage restrictions); (4) financing for Code section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities; and (5) qualified private activity bond financing for specified private projects and programs (including, for example, mass commuting facilities, solid waste disposal facilities, low-income residential rental housing projects, and single-family housing for low and moderate income homebuyers, among others), which are subject to annual state bond volume caps with certain exceptions.

Reasons for Change

The Build America Bond program has been successful and has expanded the market for State and local governmental debt. From April 2009 through December 2010, more than $181 billion in Build America Bonds were issued in over 2,275 transactions in all 50 States, the District of Columbia, and two territories. During 2009-2010, Build America Bonds gained a market share of over 25 percent of the total dollar supply of State and local governmental debt. This program taps into a broader market for investors without regard to tax liability (e.g., pension funds may be investors in Build America Bonds, though they typically do not invest in tax-exempt bonds). By comparison, traditional tax-exempt bonds have a narrower class of investors with tax preferences, which generally consist of retail investors (individuals and mutual funds hold over 70 percent of tax-exempt bonds). This program delivers an efficient Federal subsidy directly to State and local governments (rather than through third-party investors). By comparison, tax-exempt bonds can be viewed as inefficient in that the Federal revenue cost of the tax exemption is often greater than the benefits to State and local governments achieved through lower borrowing costs. This program also has a potentially more streamlined tax compliance framework focusing directly on governmental issuers who benefit from the subsidy, as compared with tax-exempt bonds and tax credit bonds which involve investors as tax intermediaries. This program also has relieved supply pressures in the tax-exempt bond market and has helped to reduce interest rates in that market. Making the Build America Bond program permanent could promote market certainty and greater liquidity.

The 35-percent Federal subsidy rate for the original Build America Bond program represented a deeper Federal borrowing subsidy for temporary stimulus purposes under ARRA than the existing permanent Federal subsidy inherent in tax-exempt bonds. In structuring a permanent Build America Bond program in light of Federal revenue constraints, it is appropriate to develop a revenue neutral Federal subsidy rate relative to the Federal tax expenditure on tax-exempt bonds. A phase-in of such a revenue neutral Federal subsidy rate may help State and local governments accelerate important investments and promote usage of the program.

For such a revenue neutral Federal subsidy rate, it also is appropriate to expand the eligible uses for Build America Bonds to include other program purposes for which tax-exempt bonds may be used.

Proposal

Permanent Program for Build America Bonds. This proposal would make the Build America Bonds program permanent at a Federal subsidy level equal to 30 percent through 2013 and 28 percent of the coupon interest on the bonds thereafter. The 28-percent Federal subsidy level is intended to be approximately revenue neutral relative to the estimated future Federal tax expenditure for tax-exempt bonds. A permanent Build America Bonds program should facilitate greater efficiency, a broader investor base, and lower costs for State and local governmental debt.

Expanded Uses. This proposal would also expand the eligible uses for Build America Bonds to include the following: (1) original financing for governmental capital projects, as under the initial authorization of Build America Bonds; (2) current refundings of prior public capital project financings for interest cost savings where the prior bonds are repaid promptly within ninety days of issuance of the current refunding bonds; (3) short-term governmental working capital financings for governmental operating expenses (such as tax and revenue anticipation borrowings for seasonal cash flow deficits), subject to a thirteen-month maturity limitation; and (4) financing for Section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities.

This proposal would be effective for bonds issued after the date of enactment.

TAX CUTS FOR FAMILIES AND INDIVIDUALS

EXTEND THE AMERICAN OPPORTUNITY TAX CREDIT (AOTC)

Current Law

Prior to enactment of the American Recovery and Reinvestment Act of 2009 (ARRA) an individual taxpayer could claim a nonrefundable Hope Scholarship credit for 100 percent of the first $1,200 and 50 percent of the next $1,200 in qualified tuition and related expenses (for a maximum credit of $1,800) per student. The Hope Scholarship credit was available only for the first two years of postsecondary education.

Alternatively, a taxpayer could claim a nonrefundable Lifetime Learning Credit (LLC) for 20 percent of up to $10,000 in qualified tuition and related expenses (for a maximum credit of $2,000) per taxpayer. Both the Hope Scholarship credit and LLC were phased out in 2009 between $50,000 and $60,000 of adjusted gross income ($100,000 and $120,000 if married filing jointly). In addition, through 2011, a taxpayer could claim an above-the-line deduction for qualified tuition and related expenses. The maximum amount of the deduction was $4,000.

ARRA created the AOTC to replace the Hope Scholarship credit for taxable years 2009 and 2010. The Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010 extended the AOTC to taxable years 2011 and 2012. The AOTC is partially refundable, has a higher maximum credit amount, is available for the first four years of postsecondary education, and has higher income phase-out limits.

The AOTC equals 100 percent of the first $2,000, plus 25 percent of the next $2,000, of qualified tuition and related expenses (for a maximum credit of $2,500). For the AOTC, the definition of related expenses was expanded to include course materials. Forty percent of the otherwise allowable AOTC is refundable (for a maximum refundable credit of $1,000). The credit is available for the first four years of postsecondary education. The credit phases out for taxpayers with adjusted gross income between $80,000 and $90,000 ($160,000 and $180,000 if married filing jointly).

All other aspects of the Hope Scholarship credit are retained under the AOTC. These include the requirement that AOTC recipients be enrolled at least half-time.

Reasons for Change

The AOTC makes college more affordable for millions of middle-income families and for the first time makes college tax incentives partially refundable. If college is not made more affordable, our nation runs the risk of losing a whole generation of potential and productivity.

Making the AOTC partially refundable increases the likelihood that low-income families will send their children to college. Under prior law, low-income families (those without sufficient income tax liability) could not benefit from the Hope Scholarship credit or the Lifetime Learning Credit because they were not refundable. Under the proposal, low-income families could benefit from the refundable portion of the AOTC. In 2011, the maximum available credit covered about 80 percent of tuition and fees at the average 2-year public institution, or about a third of tuition and fees at the average four-year public institution.

Moreover, the AOTC is available for the first four years of college, instead of only the first two years of college, increasing the likelihood that students will stay in school and attain their degrees. More years of schooling translates into higher future incomes (on average) for students and a more educated workforce for the country.

Finally, the higher phase-out thresholds under the AOTC give targeted tax relief to an even greater number of middle-income families facing the high costs of college.

Proposal

The proposal would make the AOTC a permanent replacement for the Hope Scholarship credit. To preserve the value of the AOTC, the proposal would index the $2,000 tuition and expense amounts, as well as the phase-out thresholds, for inflation.

This proposal would be effective for taxable years beginning after December 31, 2012.

PROVIDE FOR AUTOMATIC ENROLLMENT IN INDIVIDUAL RETIREMENT ACCOUNTS OR ANNUITIES (IRAS), INCLUDING A SMALL EMPLOYER TAX CREDIT, AND DOUBLE THE TAX CREDIT FOR SMALL EMPLOYER PLAN START-UP COSTS

Current Law

A number of tax-preferred, employer-sponsored retirement savings programs exist under current law. These include section 401(k) cash or deferred arrangements, section 403(b) programs for public schools and charitable organizations, section 457 plans for governments and nonprofit organizations, and simplified employee pensions (SEPs) and SIMPLE plans for small employers.

Small employers (those with no more than 100 employees) that adopt a new qualified retirement, SEP or SIMPLE plan are entitled to a temporary business tax credit equal to 50 percent of the employer's plan "start-up costs," which are the expenses of establishing or administering the plan, including expenses of retirement-related employee education with respect to the plan. The credit is limited to a maximum of $500 per year for three years.

Individuals who do not have access to an employer-sponsored retirement savings arrangement may be eligible to make smaller tax-favored contributions to IRAs.

In 2012, IRA contributions are limited to $5,000 a year (plus $1,000 for those age 50 or older). Section 401(k) plans permit contributions (employee plus employer contributions) of up to $50,000 a year (of which $17,000 can be pre-tax employee contributions) plus $5,500 of additional pre-tax employee contributions for those age 50 or older.

Reasons for Change

For many years, until the recent economic downturn, the personal saving rate in the United States has been exceedingly low, and tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement. In addition, the proportion of U.S. workers participating in employer-sponsored plans has remained stagnant for decades at no more than about half the total work force, notwithstanding repeated private- and public-sector efforts to expand coverage. Among employees eligible to participate in an employer-sponsored retirement savings plan such as a 401(k) plan, participation rates typically have ranged from two-thirds to three-quarters of eligible employees, but making saving easier by making it automatic has been shown to be remarkably effective at boosting participation.

Beginning in 1998, Treasury and the Internal Revenue Service (IRS) issued a series of rulings and other guidance (most recently in September 2009) defining, permitting, and encouraging automatic enrollment in 401(k) and other plans (i.e., enrolling employees by default unless they opt out). Automatic enrollment was further facilitated by the Pension Protection Act of 2006. In 401(k) plans, automatic enrollment has tended to increase participation rates to more than nine out of ten eligible employees. In contrast, for workers who lack access to a retirement plan at their workplace and are eligible to engage in tax-favored retirement saving by taking the initiative and making the decisions required to establish and contribute to an IRA, the IRA participation rate tends to be less than one out of ten.

Numerous employers, especially those with smaller or lower-wage work forces, have been reluctant to adopt a retirement plan for their employees, in part out of concern about their ability to afford the cost of making employer contributions or the per-capita cost of complying with tax-qualification and ERISA (Employee Retirement Income Security Act) requirements. These employers could help their employees save -- without employer contributions or plan qualification or ERISA compliance -- simply by making their payroll systems available as a conduit for regularly transmitting employee contributions to an employee's IRA. Such "payroll deduction IRAs" could build on the success of workplace-based payroll-deduction saving by using the capacity to promote saving that is inherent in employer payroll systems, and the effort to help employees save would be especially effective if automatic enrollment were used. However, despite efforts more than a decade ago by the Department of the Treasury, the IRS, and the Department of Labor to approve and promote the option of payroll deduction IRAs, few employers have adopted them or even are aware that this option exists.

Accordingly, requiring employers that do not sponsor any retirement plan (and meet other criteria such as being above a certain size) to make their payroll systems available to employees and automatically enroll them in IRAs could achieve a major breakthrough in retirement savings coverage. In addition, requiring automatic IRAs may lead many employers to take the next step and adopt an employer plan, thereby permitting much greater tax-favored employee contributions than an IRA, plus the option of employer contributions. The potential for the use of automatic IRAs to lead to the adoption of 401(k)s, SIMPLEs, and other employer plans would be enhanced by raising the existing small employer tax credit for the start-up costs of adopting a new retirement plan to an amount significantly higher than both its current level and the level of the proposed new automatic IRA tax credit for employers.

In addition, the process of saving and choosing investments in automatic IRAs could be simplified for employees, and costs minimized, through a standard default investment as well as electronic information and fund transfers. Workplace retirement savings arrangements made accessible to most workers also could be used as a platform to provide and promote retirement distributions over the worker's lifetime.

Proposal

The proposal would require employers in business for at least two years that have more than ten employees to offer an automatic IRA option to employees, under which regular contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsored a qualified retirement plan, SEP, or SIMPLE for its employees, it would not be required to provide an automatic IRA option for its employees. Thus, for example, a qualified plan sponsor would not have to offer automatic IRAs to employees it excludes from qualified plan eligibility because they are covered by a collective bargaining agreement, are under age eighteen, are nonresident aliens, or have not completed the plan's eligibility waiting period. However, if the qualified plan excluded from eligibility a portion of the employer's work force or a class of employees such as all employees of a subsidiary or division, the employer would be required to offer the automatic IRA option to those excluded employees.

The employer offering automatic IRAs would give employees a standard notice and election form informing them of the automatic IRA option and allowing them to elect to participate or opt out. Any employee who did not provide a written participation election would be enrolled at a default rate of three percent of the employee's compensation in an IRA. Employees could opt out or opt for a lower or higher contribution rate up to the IRA dollar limits. Employees could choose either a traditional IRA or a Roth IRA, with Roth being the default. For most employees, the payroll deductions would be made by direct deposit similar to the direct deposit of employees' paychecks to their accounts at financial institutions.

Payroll-deduction contributions from all participating employees could be transferred, at the employer's option, to a single private-sector IRA trustee or custodian designated by the employer. Alternatively, the employer, if it preferred, could allow each participating employee to designate the IRA provider for that employee's contributions or could designate that all contributions would be forwarded to a savings vehicle specified by statute or regulation.

Employers making payroll deduction IRAs available would not have to choose or arrange default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed by statute or regulation. In addition, this approach would involve no employer contributions, no employer compliance with qualified plan requirements, and no employer liability or responsibility for determining employee eligibility to make tax-favored IRA contributions or for opening IRAs for employees. A national web site would provide information and basic educational material regarding saving and investing for retirement, including IRA eligibility, but, as under current law, individuals (not employers) would bear ultimate responsibility for determining their IRA eligibility.

Contributions by employees to automatic IRAs would qualify for the saver's credit to the extent the contributor and the contributions otherwise qualified.

Small employers (those that have no more than 100 employees) that offer an automatic IRA arrangement could claim a temporary non-refundable tax credit for the employer's expenses associated with the arrangement up to $500 for the first year and $250 for the second year. Furthermore, these employers would be entitled to an additional non-refundable credit of $25 per enrolled employee up to $250 for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (for example, because they have ten or fewer employees).

In conjunction with the automatic IRA proposal, to encourage employers not currently sponsoring a qualified retirement plan, SEP, or SIMPLE to do so, the non-refundable "start-up costs" tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE would be doubled from the current maximum of $500 per year for three years to a maximum of $1,000 per year for three years and extended to four years (rather than three) for any employer that adopts a new qualified retirement plan, SEP, or SIMPLE during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This expanded "start-up costs" credit for small employers, like the current "start-up costs" credit, would not apply to automatic or other payroll deduction IRAs. The expanded credit would encourage small employers that would otherwise adopt an automatic IRA to adopt a new 401(k), SIMPLE, or other employer plan instead, while also encouraging other small employers to adopt a new employer plan.

The proposal would become effective after December 31, 2013.

EXPAND THE EARNED INCOME TAX CREDIT (EITC) FOR LARGER FAMILIES

Current Law

Low and moderate-income workers may be eligible for a refundable EITC. Eligibility for the EITC is based on the presence and number of qualifying children in the worker's household, adjusted gross income (AGI), earned income, investment income, filing status, age, and immigration and work status in the United States. The amount of the EITC is based on the number of qualifying children in the worker's household, AGI, earned income, and filing status.

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a maximum range (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit).

The EITC phases in at a faster rate for workers with more qualifying children, resulting in a larger maximum credit and a longer phase-out range. Prior to the enactment of the American Recovery and Reinvestment Act (ARRA), the credit reached its maximum at two or more qualifying children. ARRA increased the phase-in rate for families with three or more qualifying children through 2010. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended this provision through 2012. After 2012, workers with three or more qualifying children will receive the same EITC as similarly situated workers with two qualifying children.

The phase-out range for joint filers begins at a higher income level than for an individual with the same number of qualifying children who files as a single filer or as a head of household. The width of the phase-in range and the beginning of the phase-out range are indexed for inflation. Hence, the maximum amount of the credit and the end of the phase-out range are effectively indexed. The following chart summarizes the EITC parameters for 2012.

	Childless Taxpayers	Taxpayers with Qualifying Children		
		One Child	Two Children	Three or More
Phase-in rate	7.65%	34.00%	40.00%	45.00%
Minimum earnings for maximum credit	$6,210	$9,320	$13,090	$13,090
Maximum credit	$475	$3,169	$5,236	$5,891
Phase-out rate	7.65%	15.98%	21.06%	21.06%
Phase-out begins	$7,770 ($12,980 joint)	$17,090 ($22,300 joint)	$17,090 ($22,300 joint)	$17,090 ($22,300 joint)
Phase-out ends	$13,980 ($19,190 joint)	$36,920 ($42,130 joint)	$41,952 ($47,162 joint)	$45,060 ($50,270 joint)

To be eligible for the EITC, workers must have no more than $3,200 of investment income. (This amount is indexed for inflation.)

Reasons for Change

Families with more children face larger expenses related to raising their children than families with fewer children and as a result tend to have higher poverty rates. The steeper phase-in rate and larger maximum credit for workers with three or more qualifying children helps workers with larger families meet their expenses while maintaining work incentives.

Proposal

The proposal would make permanent the expansion of the EITC for workers with three or more qualifying children. Specifically, the phase-in rate of the EITC for workers with three or more qualifying children would be maintained at 45 percent, resulting in a higher maximum credit amount and a longer phase-out range.

The proposal would be effective for taxable years beginning after December 31, 2012.

EXPAND THE CHILD AND DEPENDENT CARE TAX CREDIT

Current Law

In 2012, taxpayers with child or dependent care expenses who are working or looking for work are eligible for a nonrefundable tax credit that partially offsets these expenses. Married couples are eligible only if they file a joint return and either both spouses are working or looking for work, or if one spouse is working or looking for work and the other is attending school full-time. To qualify for this benefit, the child and dependent care expenses must be for either (1) a child under age thirteen when the care was provided or (2) a disabled dependent of any age with the same place of abode as the taxpayer. Any allowable credit is reduced by the aggregate amount excluded from income under an employer-provided dependent care assistance program.

Eligible taxpayers may claim the credit for up to 35 percent of up to $3,000 in eligible expenses for one child or dependent and up to $6,000 in eligible expenses for more than one child or dependent. The percentage of expenses for which a credit may be taken decreases by 1 percentage point for every $2,000 (or part thereof) of adjusted gross income (AGI) over $15,000 until the percentage of expenses reaches 20 percent (at incomes above $43,000). There are no further income limits. The phase-down point and the amount of expenses eligible for the credit are not indexed for inflation.

Reasons for Change

Access to affordable child care is a barrier to employment or further schooling for some individuals. Assistance to individuals with child and dependent care expenses increases the ability of individuals to participate in the labor force or in education programs.

Proposal

The proposal would permanently increase from $15,000 to $75,000 the AGI level at which the credit begins to phase down. The percentage of expenses for which a credit may be taken would decrease at a rate of 1 percentage point for every $2,000 (or part thereof) of AGI over $75,000 until the percentage reached 20 percent (at incomes above $103,000). As under current law, there would be no further income limits and the phase-down point and the amount of expenses eligible for the credit would not be indexed for inflation.

The proposal would be effective for taxable years beginning after December 31, 2012.

EXTEND EXCLUSION FROM INCOME FOR CANCELLATION OF CERTAIN HOME MORTGAGE DEBT

Current Law

Gross income generally includes income that is realized by a debtor from the discharge of indebtedness. Exceptions to this general rule include exclusions for debtors in Title 11 bankruptcy cases, for insolvent debtors, for discharges of certain farm and non-farm business indebtedness, and for discharges of qualified principal residence indebtedness (QPRI). Most of the exceptions require taxpayers to take steps (such as reducing basis) to merely defer the income from the discharge rather than excluding it permanently. The amount of discharge generally is the excess of the adjusted issue price of the debt being discharged over the amount, if any, that the borrower uses to satisfy the debt. If a modification of indebtedness is treated as an exchange of an old debt instrument for a new one, these rules apply (as they do for all debt-for-debt exchanges). For this purpose, if the debtor issues a new debt instrument in satisfaction of the old one, the debtor is treated as having satisfied the old debt with an amount of money equal to the issue price of the new one.

QPRI is acquisition indebtedness with respect to the taxpayer's principal residence (limited to $2 million). Acquisition indebtedness with respect to a principal residence generally means indebtedness that is incurred in the acquisition, construction, or substantial improvement of the taxpayer's principal residence and that is secured by the residence. It also includes refinancing of preexisting acquisition indebtedness to the extent the amount of the new debt does not exceed the old.

If, immediately before the discharge, only a portion of discharged indebtedness is QPRI, then the discharge is treated as applying first to the portion of the debt that is *not* QPRI, and thus the exclusion applies only to the extent that the total discharge was greater than that non-QPRI portion. The basis of the taxpayer's principal residence is reduced by the amount excluded from income under the provision.

The exclusion for discharges of QPRI was added to the Internal Revenue Code in 2007, effective for discharges in 2007 through 2009. In 2008, the exclusion was extended to discharges in 2010, 2011, and 2012.

Reasons for Change

In recent years, home values in regions across the country have fallen substantially, leaving millions of homeowners now owing more on their mortgage loans than the value of the homes securing those loans. Many homeowners are also experiencing difficulty making timely payments on their mortgage loans. In these circumstances, there is a substantial volume of foreclosures. In addition, it is often in the best interests of both the homeowner and the holder of the mortgage to avoid foreclosure in one of several ways. For example, the homeowner may sell the home for less than the amount owed on the mortgage loan, and (despite the shortfall) the holder of the loan accepts the sales proceeds in full satisfaction of the loan. Alternatively, the homeowner may transfer title to the house to the lender in return for cancelation of the mortgage. Or, the homeowner and the holder may agree for the loan to be modified so that the homeowner can again become timely. Thus, although there has been improvement in the residential real estate market, there is still an elevated number of cases in which homeowners may have discharge of indebtedness income with respect to their home mortgage loans.

Beyond the many modifications being made without Government assistance, there are large numbers of mortgage modifications under programs run by Making Home Affordable (an official program of the U.S. Department of the Treasury), especially the Home Affordable Modification Program^{SM} (HAMP^{SM}). Facilitating home mortgage modifications remains important for the continued recovery of the residential real estate market. The importance is demonstrated by the fact that HAMP has been extended through the end of 2013. Moreover, an increased volume of non-Government-assisted modifications is likely to persist beyond that date.

Many modifications that are sufficiently significant to be treated as debt-for-debt exchanges involve cancellation of some portion of the debt. In most cases, exclusion of the discharge of QPRI prevents tax consequences from complicating and possibly deterring these modifications. Because of the continued importance of facilitating home mortgage modifications, the currently scheduled expiration for the exclusion of discharges of QPRI should be delayed.

<u>Proposal</u>

The exclusion for income from the discharge of QRPI would be extended to amounts that are discharged before January 1, 2015, and to amounts that are discharged pursuant to an agreement entered before that date. Thus, for example, the exclusion could apply to delayed discharges that occur after trial periods that were agreed to before January 1, 2015. An extension beyond January 1, 2015, may be appropriate to correspond to the availability of additional homeowner relief as a result of government actions or other arrangements.

PROVIDE EXCLUSION FROM INCOME FOR STUDENT LOAN FORGIVENESS FOR STUDENTS AFTER 25 YEARS OF INCOME-BASED OR INCOME-CONTINGENT REPAYMENT

Current Law

In general, loan amounts that are forgiven are considered gross income to the borrower and subject to individual income tax in the year of discharge. Exceptions exist for certain student loan repayment programs. Specifically, students who participate in the National Health Service Corps Loan Repayment program, certain state loan repayment programs, and certain profession-based loan programs may exclude discharged amounts from gross income.

Students with higher education expenses may be eligible to borrow money for their education through the Federal Direct Loan Program. Prior to July 1, 2010, they may also have been eligible to borrow money through the Federal Family Education Loan Program. Both programs are administered by the Department of Education. Each program provides borrowers with an option for repaying the loan that is related to the borrower's income level after college (the income-contingent and the income-based repayment options). Under both of these options borrowers complete their repayment obligation when they have repaid the loan in full, with interest, or have made those payments that are required under the plan for 25 years. For those who reach the 25-year point, any remaining loan balance is forgiven. Under current law, any debt forgiven by these programs is considered gross income to the borrower and thus subject to individual income tax.

Reason for Change

At the time the loans are forgiven, the individuals who have met the requirements for debt forgiveness in the income-contingent and the income-based repayment programs would have been making payments for 25 years. In general, these individuals will have had low incomes relative to their debt burden for many years. For many of these individuals, paying the tax on the forgiven amounts will be difficult. Furthermore, the potential tax consequence may be making some student loan borrowers reluctant to accept forgiveness of the loan.

Proposal

The proposal would exclude from gross income amounts forgiven at the end of the repayment period for Federal student loans using the income-contingent repayment option or the income-based repayment option.

The provision would be effective for loans forgiven after December 31, 2012.

PROVIDE EXCLUSION FROM INCOME FOR STUDENT LOAN FORGIVENESS AND FOR CERTAIN SCHOLARSHIP AMOUNTS FOR PARTICIPANTS IN THE INDIAN HEALTH SERVICE (IHS) HEALTH PROFESSIONS PROGRAMS

Current Law

Gross income generally does not include certain scholarship amounts that are used to pay tuition, required fees, and related expenses (e.g. books, certain computing equipment, fees, and supplies). Amounts for other expenses, including child care and travel not incidental to the scholarship, are included in income. However, if the scholarship represents payment for teaching, research, or other services required as a condition for receiving the scholarship, including a future work obligation, the scholarship is considered ordinary income (i.e. wages) and is thus taxable. An exception to this rule exists for recipients of National Health Service Corp (NHSC) scholarships and Armed Forces Health Professions (AFHP) scholarships. (Scholarship amounts used to pay nonqualified expenses are taxable as ordinary income.)

In most cases, loan amounts forgiven or repaid on an individual's behalf are considered ordinary income and thus, are taxable. However, certain student loan debt that is forgiven or cancelled is excluded from income. This includes debt repaid under the NHSC Loan Repayment Program and under certain state programs intended to increase the availability of health care services in underserved areas.

The IHS Health Professions Scholarship Program and IHS Loan Forgiveness Program improve access to medical care for Indian and Alaska Natives by providing physicians and other health professionals to IHS facilities. Participants in the scholarship program commit to a term of employment at IHS facilities upon completion of their training. Participants in the loan repayment program serve at IHS facilities in exchange for loan repayment. Similarly, NHSC participants commit to employment at approved facilities that provide health care to underserved populations in exchange for scholarship funds and/or repayment of their student loans. IHS facilities are approved locations for NHSC participants.

Reasons for Change

The IHS Health Professions Scholarship and IHS Loan Forgiveness Program are very similar to other programs that receive preferred tax treatment, and therefore should receive the same tax treatment.

Proposal

Allow scholarship funds for qualified tuition and related expenses received under the IHS Health Professions Scholarship program to be excluded from income, even though recipients incur a work requirement. Furthermore, allow participants in the IHS Loan Repayment Program to exclude from income student loan amounts that are forgiven by the IHS Loan Repayment program. This proposal would apply exclusively to the programs described in Section 104 and 108 of the Indian Health Care Improvement Act (Public Law 94-437). The tax treatment of all other IHS programs would be unchanged.

The proposal would be effective for tax years beginning after December 31, 2012.

INCENTIVES FOR EXPANDING MANUFACTURING AND INSOURCING JOBS IN AMERICA

PROVIDE TAX INCENTIVES FOR LOCATING JOBS AND BUSINESS ACTIVITY IN THE UNITED STATES AND REMOVE TAX DEDUCTIONS FOR SHIPPING JOBS OVERSEAS

Current Law

Under current law, there are limited tax incentives for U.S. employers to bring offshore jobs and investments into the United States. In addition, costs incurred to outsource U.S. jobs generally are deductible for U.S. income tax purposes.

Reasons for Change

On January 11, the White House released a report that details the emerging trend of "insourcing" and how companies are increasingly choosing to invest in the United States. For example, real business fixed investment has grown by about 18 percent since the end of 2009. In the past two years, over 400,000 manufacturing jobs have been created, while manufacturing production has increased by about 5.7 percent on an annualized basis since its low in June of 2009, its fastest pace in a decade. In addition, continued productivity growth has made the United States more competitive in attracting businesses to invest and create jobs by reducing the relative cost of doing business compared to other countries. The Administration would like to make the United States more competitive in attracting businesses by creating a tax incentive to bring offshore jobs and investments back into the United States. In addition, the Administration would like to reduce the tax benefits that exist under current law for expenses incurred to move U.S. jobs offshore.

Proposal

The proposal would create a new general business credit against income tax equal to 20 percent of the eligible expenses paid or incurred in connection with insourcing a U.S. trade or business. For this purpose, insourcing a U.S. trade or business means reducing or eliminating a trade or business (or line of business) currently conducted outside the U.S. and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. While the creditable costs may be incurred by the foreign subsidiary of the U.S.-based multinational company, the tax credit would be claimed by the U.S. parent company. A similar benefit would be extended to non-mirror code possessions (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

In addition, to reduce tax benefits associated with U.S. companies' moving jobs offshore, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business. For this purpose, outsourcing a U.S. trade or business means reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In determining the subpart F income of a controlled foreign corporation, no reduction would be allowed for any expenses associated with moving a U.S. trade or business outside the United States.

For purposes of the proposal, expenses paid or incurred in connection with insourcing or outsourcing a U.S. trade or business are limited solely to expenses associated with the relocation of the trade or business and do not include capital expenditures or costs for severance pay and other assistance to displaced workers. The Secretary may prescribe rules to implement the provision, including rules to determine covered expenses.

The proposal would be effective for expenses paid or incurred after the date of enactment.

PROVIDE NEW MANUFACTURING COMMUNITIES TAX CREDIT

Current Law

Under current law, there is no tax incentive directly targeted to investments in communities that do not necessarily qualify as low-income communities, but that have suffered or expect to suffer an economic disruption as a result of a major job loss event, such as a military base closing or manufacturing plant closing.

Reasons for Change

The loss of a major employer can devastate a community, and incentives, including tax incentives, could encourage investments that help such affected communities recover quickly from the economic disruption.

Proposal

The Administration proposes a new allocated tax credit to support investments in communities that have suffered a major job loss event. For this purpose, a major job loss event occurs when a military base closes or a major employer closes or substantially reduces a facility or operating unit, resulting in a long-term mass layoff. Applicants for the credit would be required to consult with relevant state or local Economic Development Agencies (or similar entities) in selecting those investments that qualify for the credit. The credit could be structured using the mechanism of the New Markets Tax Credit or as an allocated investment credit similar to the Qualifying Advanced Energy Project Credit. The Administration intends to work with Congress to craft the appropriate structure and selection criteria. Similar benefits would be extended to non-mirror code possessions (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

The proposal would provide about $2 billion in credits for qualified investments approved in each of the three years, 2012 through 2014.

TARGET THE DOMESTIC PRODUCTION DEDUCTION TO DOMESTIC MANUFACTURING ACTIVITIES AND DOUBLE THE DEDUCTION FOR ADVANCED MANUFACTURING ACTIVITIES

Current Law

Current law allows a deduction to taxpayers that generate qualified production activities income. Such income is generally calculated as a taxpayer's domestic production gross receipts (DPGR) less the cost of goods sold and other expenses, losses, or deductions attributable to such receipts. DPGR are those gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of (1) qualifying production property (tangible personal property, computer software, and sound recordings) manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States; (2) any qualified film produced by the taxpayer (where not less than 50 percent of the total compensation is for labor services performed in the United States); or (3) electricity, natural gas, or potable water produced by the taxpayer in the United States. DPGR also include gross receipts derived from the construction of real property performed in the United States, including receipts derived from the conduct of related engineering or architectural services.

The domestic production deduction is generally equal to nine percent of the taxpayer's qualified production activities income (or of its taxable income, computed before the deduction, if less) for the taxable year. It is computed at a 6 percent rate for income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. The deduction may not exceed 50 percent of wages (including amounts of elective deferrals and deferred compensation) paid by the taxpayer for the taxable year that are attributable to DPGR.

Reasons for Change

The current domestic production deduction applies to a broad range of activities beyond core manufacturing activities. Broadening the income tax base by narrowing the scope of the domestic production deduction would allow an increased deduction rate for the activities remaining subject to the provision, and would allow for an even greater incentive for the manufacture of certain advanced technology property.

Proposal

The proposal would limit the extent to which the domestic production deduction is allowed with respect to nonmanufacturing activities by excluding from the definition of DPGR any gross receipts derived from sources such as the production of oil and gas, the production of coal and other hard mineral fossil fuels, and certain other nonmanufacturing activities. Additional revenue obtained from this retargeting would be used to increase the general deduction percentage and to fund an increase of the deduction rate for activities involving the manufacture of certain advanced technology property to approximately 18 percent. The proposal would be roughly revenue neutral over the ten-year budget window.

The proposal would be effective for taxable years beginning after December 31, 2012.

ENHANCE AND MAKE PERMANENT THE RESEARCH AND EXPERIMENTATION (R&E) TAX CREDIT

Current Law

The R&E tax credit is 20 percent of qualified research expenses above a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years. The taxpayer's fixed base percentage generally is the ratio of its research expenses to gross receipts for the 1984-88 period. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year. Taxpayers can elect the alternative simplified research credit (ASC), which is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. Under the ASC, the rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the ASC applies to all succeeding taxable years unless revoked with the consent of the Secretary.

The R&E tax credit also provides a credit for 20 percent of: (1) basic research payments above a base amount; and (2) all eligible payments to an energy research consortium for energy research.

The R&E tax credit expired on December 31, 2011.

Reasons for Change

The R&E tax credit encourages technological developments that are an important component of economic growth. However, uncertainty about the future availability of the R&E tax credit diminishes the incentive effect of the credit because it is difficult for taxpayers to factor the credit into decisions to invest in research projects that will not be initiated and completed prior to the credit's expiration. To improve the credit's effectiveness, the R&E tax credit should be made permanent.

Currently, a taxpayer must choose between using an outdated formula for calculating the R&E credit that provides a 20-percent credit rate for research spending over a certain base amount related to the business's historical research intensity and the much simpler ASC that provides a 14-percent credit in excess of a base amount based on its recent research spending. Increasing the rate of the ASC to 17 percent would provide an improved incentive to increase research and would make the ASC a more attractive alternative. Because the ASC base is updated annually, the ASC more accurately reflects the business's recent research experience and simplifies the R&E credit's computation.

Proposal

The proposal would make the R&E credit permanent and increase the rate of the ASC from 14 percent to 17 percent, effective after December 31, 2011.

PROVIDE A TAX CREDIT FOR THE PRODUCTION OF ADVANCED TECHNOLOGY VEHICLES

Current Law

A tax credit is allowed for plug-in electric drive motor vehicles. A plug-in electric drive motor vehicle is a vehicle that has at least four wheels, is manufactured for use on public roads, is treated as a motor vehicle for purposes of title II of the Clean Air Act (that is, is not a low-speed vehicle), has a gross vehicle weight of less than 14,000 pounds, meets certain emissions standards, draws propulsion energy using a traction battery with at least four kilowatt hours of capacity, is capable of being recharged from an external source, and meets certain other requirements. The credit is $2,500 plus $417 for each kilowatt hour of battery capacity in excess of four kilowatt hours, up to a maximum credit of $7,500. The credit phases out for a manufacturer's vehicles over four calendar quarters beginning with the second calendar quarter following the quarter in which 200,000 of the manufacturer's credit-eligible vehicles have been sold. The credit is generally allowed to the taxpayer that places the vehicle in service (including a person placing the vehicle in service as a lessor). In the case of a vehicle used by a tax-exempt or governmental entity, however, the credit is allowed to the person selling the vehicle to the tax-exempt or governmental entity, but only if the seller clearly discloses the amount of the credit to the purchaser.

Reasons for Change

In 2008, the President set a goal of putting 1 million advanced technology vehicles on the road by 2015 – which would reduce dependence on foreign oil and lead to a reduction in oil consumption of about 750 million barrels through 2030. To help achieve that goal, the President is proposing increased investment in R&D and a competitive program to encourage communities to invest in the advanced vehicle infrastructure, address the regulatory barriers, and provide the local incentives to achieve deployment at critical mass. The President is also proposing a transformation of the existing tax credit for plug-in electric drive motor vehicles into one that is allowed for a wider range of advanced technologies and that is allowed generally to the seller.

Making the credit available to a wider range of technologies, removing the cap placed on the number of vehicles per manufacturer that can receive the credit, and allowing for a scalable credit up to a maximum of $10,000 will help increase production of advanced vehicles that diversify our fuel use and bring down the cost of producing such vehicles. Moving eligibility for the credit from the purchaser to the person that sells or finances the sale of the vehicle to the ultimate owner would enable the seller or person financing the sale to offer a point-of-sale rebate to consumers. Disclosure requirements, similar to those currently applicable in the case of sales to tax-exempt and governmental entities, would help ensure that the benefit of the credit is passed on to consumers. Shifting the process of claiming the credit from a large number of individual consumers to a relatively small number of business entities would also simplify tax preparation for individuals and reduce the potential for taxpayer error.

Proposal

The proposal would replace the credit for plug-in electric drive motor vehicles with a credit for advanced technology vehicles. The credit would be available for a vehicle that meets the following criteria: (1) the vehicle operates primarily on an alternative to petroleum; (2) as of the January 1, 2012, there are few vehicles in operation in the U.S. using the same technology as such vehicle; and (3) the technology used by the vehicle exceeds the footprint based target miles per gallon gasoline equivalent (MPGe) by at least 25 percent. The Secretary of the Treasury, in consultation with the Secretary of Energy, will determine what constitutes the same technology for this purpose. The credit would be limited to vehicles that weigh no more than 14,000 pounds and are treated as motor vehicles for purposes of title II of the Clean Air Act. In general, the credit would be the product of $5,000 and 100 and the amount by which the vehicle's footprint gallons per mile exceeds its gallons per mile, but would be capped at $10,000 ($7,500 for vehicles with an MSRP above $45,000). The credit for a battery-powered vehicle would be determined under current law rules for the credit for plug-in electric drive motor vehicles if that computation results in a greater credit. The credit would be allowed to the person that sold the vehicle to the person placing the vehicle in service (or, at the election of the seller, to the person financing the sale), but only if the amount of the credit is disclosed to the purchaser.

The credit would be allowed for vehicles placed in service after the date of enactment and before January 1, 2020. The credit would be limited to 75 percent of the otherwise allowable amount for vehicles placed in service in 2017, to 50 percent of such amount for vehicles placed in service in 2018, and to 25 percent of such amount for vehicles placed in service in 2019.

PROVIDE A TAX CREDIT FOR MEDIUM- AND HEAVY-DUTY ALTERNATIVE-FUEL COMMERCIAL VEHICLES

Current Law

A tax credit is allowed for fuel-cell vehicles purchased before 2015. The credit is $20,000 for vehicles weighing more than 14,000 pounds but not more than 26,000 pounds and $40,000 for vehicles weighing more than 26,000 pounds. There is no other tax incentive for vehicles weighing more than 14,000 pounds.

Reasons for Change

Currently, medium- and heavy-duty trucks consume more than two million barrels of oil every day and account for 20 percent of greenhouse gas emissions related to transportation. Most of these vehicles are powered by diesel fuel. Alternative-fuel vehicles have the potential to reduce petroleum consumption and greenhouse gas emissions. A tax credit would encourage the purchase of such vehicles and the development of a commercially viable manufacturing base for alternative-fuel medium and heavy-duty vehicles.

Proposal

The proposal would allow a tax credit for dedicated alternative-fuel vehicles weighing more than 14,000 pounds. The credit would be equal to 50 percent of the incremental cost of such vehicles compared to the cost of a comparable diesel or gasoline vehicle. The credit would be limited to $25,000 for vehicles weighing up to 26,000 pounds and $40,000 for vehicles weighing more than 26,000 pounds. In the case of fuel-cell vehicles, the proposed credit would be reduced by the amount of the credit allowed with respect to the vehicle under current law. The credit would be allowed to the person placing the vehicle in service or, in the case of a vehicle placed in service by a tax-exempt or governmental entity, to the person that sold the vehicle to such entity (or, at the election of the seller, to the person financing the sale), but only if the amount of the credit is disclosed to the purchaser.

The credit would be allowed for vehicles placed in service after December 31, 2012, and before January 1, 2019. For vehicles placed in service in calendar year 2018, the credit would be limited to 50 percent of the otherwise allowable amount.

EXTEND AND MODIFY CERTAIN ENERGY INCENTIVES

Current Law

The general business tax credit includes a production tax credit for wind facilities placed in service in 2012 and certain other renewable energy facilities placed in service before 2014 (the renewable electricity production tax credit). The general business credit also includes an investment tax credit for energy property. Energy property is (1) property that is part of a facility that, but for the election to claim an investment tax credit, would qualify for the renewable electricity production tax credit and (2) certain other listed property (including solar energy property).

The Secretary of the Treasury is required to make grants to persons that place in service property that, but for the receipt of the grant, would be energy property qualifying for the investment tax credit. In general, the grant is 30 percent of the basis on which the investment tax credit could be claimed. For qualified microturbine, combined heat and power systems, and geothermal heat pump property, the grant is 10 percent of such basis. If a grant is paid with respect to any property, no renewable electricity production tax credit or investment tax credit is allowed with respect to that property.

The grant was available for property that was originally placed in service in 2009, 2010, and 2011. For property placed in service after 2011, the grant is available only if construction of the property began in 2009, 2010, or 2011, and the property is placed in service before 2013 (in the case of wind facility property), 2014 (in the case of other property that is part of a facility that could, but for the receipt of the grant, qualify for the renewable electricity production tax credit), or 2017 (in the case of any other energy property).

Reasons for Change

Investments in property qualifying for the renewable electricity production tax credit and the investment tax credit for energy property further the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. The extension of incentives for these investments is necessary to the continued success of that policy. The administration of the incentives could be improved, however, if they were delivered entirely through the Internal Revenue Code by substituting a refundable tax credit for the Treasury grant program.

Proposal

The proposal would extend the production tax credit for wind facilities and the investment tax credit for wind facility property to facilities and property placed in service in 2013. The proposal would also extend the Treasury grant program to all otherwise qualifying property placed in service in 2012 (including property on which construction begins in 2012). For property that is placed in service after 2012, the proposal would replace the Treasury grant with a refundable tax credit administered by the Internal Revenue Service. The refundable tax credit would be available for property on which construction begins in 2009, 2010, 2011, 2012, or 2013. The credit would be allowed with respect to property placed in service in 2013 (in the case of property, including wind facility property, that is part of a facility eligible for the renewable electricity production tax credit) and for property placed in service in 2013, 2014, 2015, or 2016 (in the case of any other energy property). Qualification requirements for the refundable credit would be the same (except for the effective date provisions) as the qualification requirements currently applicable under the Treasury grant program.

TAX RELIEF FOR SMALL BUSINESS

ELIMINATE CAPITAL GAINS TAXATION ON INVESTMENTS IN SMALL BUSINESS STOCK

Current Law

Under the Small Business Jobs Act, taxpayers other than corporations may exclude 100 percent of the gain from the sale of qualified small business stock acquired after September 27, 2010 and before January 1, 2011, and held for at least five years, provided various requirements are met. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended this 100-percent exclusion to eligible stock acquired before January 1, 2012. The excluded gain is not a preference under the Alternative Minimum Tax (AMT) for stock acquired during this period.

Prior law provided a 50-percent exclusion (60-percent for certain empowerment zone businesses) for qualified small business stock. The taxable portion of the gain is taxed at a maximum rate of 28 percent. The AMT treats 28 percent of the excluded gain on eligible stock acquired after December 31, 2000 and 42 percent of the excluded gain on stock acquired before January 1, 2001 as a tax preference. A 75-percent exclusion enacted under the American Recovery and Reinvestment Act (ARRA) applies to qualified stock acquired after February 17, 2009, and before September 28, 2010 with 21 percent of the excluded gains subject to the AMT.

The maximum amount of gain eligible for the exclusion by a taxpayer with respect to any corporation during any year is the greater of (1) ten times the taxpayer's basis in stock issued by the corporation and disposed of during the year, or (2) $10 million reduced by gain excluded in prior years on dispositions of the corporation's stock. To qualify as a small business, the corporation, when the stock is issued, may not have gross assets exceeding $50 million (including the proceeds of the newly issued stock) and must be a C corporation.

The corporation also must meet certain active trade or business requirements. For example, the corporation must be engaged in a trade or business other than: one involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of the trade or business is the reputation or skill of one or more employees; a banking, insurance, financing, leasing, investing or similar business; a farming business; a business involving production or extraction of items subject to depletion; or a hotel, motel, restaurant or similar business. There are limits on the amount of real property that may be held by a qualified small business, and ownership of, dealing in, or renting real property is not treated as an active trade or business.

A related provision, section 1045, allows investors that sell qualified small business stock held over six months to defer recognition of capital gain by reinvesting the sales proceeds in new qualified stock within 60 days. Under this rollover provision, the investor's basis in the new stock is reduced by the amount of the deferred gain.

Reasons for Change

Making the exclusion for small business stock gain permanent would encourage and reward new investment in qualified small business stock. However, treatment of a percentage of excluded gain as a preference under the AMT eliminates almost all of the benefit of the provision for investments made before February 18, 2009. In addition, the current 60-day period for re-investment under section 1045 rollover of gain on qualified small business stock is inadequate. Increasing the time period for re-investment would increase the use of this provision and increase the supply of investment capital for small business.

Proposal

The proposal would make the 100-percent exclusion for qualified small business stock permanent. The AMT preference item for gain excluded under section 1202 would be repealed for all excluded small business stock gain. The time for a taxpayer to reinvest the proceeds of sales of small business stock under section 1045 would be increased to 6 months for qualified small business stock the taxpayer has held longer than three years. Other limitations on the section 1202 exclusion would continue to apply. The proposal would include additional information reporting requirements to assure compliance with those limitations, and taxpayers would be required to report qualified sales on their tax returns.

The proposal would be effective for qualified small business stock acquired after December 31, 2011.

DOUBLE THE AMOUNT OF EXPENSED START-UP EXPENDITURES

Current Law

Start-up expenditures consist of any amount (other than interest, taxes, or research and experimental expenditures) that would be deductible if paid or incurred in connection with the operation of an existing active trade or business, but which is instead incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

In general, a taxpayer is not allowed to deduct start-up expenditures other than as a loss upon disposition of the relevant trade or business. However, a taxpayer may elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins, and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the active trade or business begins. The $5,000 amount is reduced (but not below zero) by the amount by which start-up expenditures with respect to the active trade or business exceed $50,000.

In the case of a taxable year beginning in 2010, the Creating Small Business Jobs Act of 2010 increased the $5,000 limit on expensed start-up expenditures to $10,000, where that amount was reduced (but not below zero) by the amount by which start-up expenditures with respect to the active trade or business exceeded $60,000.

Under final Treasury regulations, a taxpayer is deemed to have made the election to expense and amortize its start-up expenditures. However, the taxpayer can choose to forgo the deemed election by affirmatively electing to capitalize its start-up expenditures on a timely filed tax return for the taxable year in which the relevant active trade or business begins. The election to amortize or capitalize start-up expenditures for an active trade or business is irrevocable and applies to all start-up expenditures related to that active trade or business.

Reason for Change

A larger immediate deduction of start-up expenditures lowers the tax cost of investigating new business opportunities and investing in new business activities. Increasing the dollar limit on expensed start-up expenditures would provide a stimulus to business formation and job creation.

Proposal

The Administration proposes to permanently double, from $5,000 to $10,000, the maximum amount of start-up expenditures that a taxpayer may deduct (in addition to amortized amounts) in the taxable year in which a trade or business begins. This maximum amount of expensed start-up expenditures would be reduced (but not below zero) by the amount by which start-up expenditures with respect to the active trade or business exceed $60,000.

The proposal would be effective for taxable years ending on or after the date of enactment.

EXPAND AND SIMPLIFY THE TAX CREDIT PROVIDED TO QUALIFIED SMALL EMPLOYERS FOR NON-ELECTIVE CONTRIBUTIONS TO EMPLOYEE HEALTH INSURANCE

Current Law

The cost to an employer of providing health coverage for its employees is generally deductible as an ordinary and necessary business expense for employee compensation. In addition, the value of employer-provided health coverage is not subject to employer-paid Federal Insurance Contributions Act (FICA) tax.

Employees are generally not taxed on the value of employer-provided health coverage for themselves, their spouses and their dependents under an accident or health plan. That is, health coverage benefits are excluded from gross income for purposes of income and employment taxes. Active employees may be able to pay for limited amounts of medical care and for their own employee premium contributions on a pre-tax basis through a cafeteria plan.

The Affordable Care Act created a tax credit to help small employers provide health insurance for employees and their families. An employer must make uniform contributions of at least 50 percent of the premium to qualify for the credit. For taxable years beginning in 2010 through 2013, the credit is available for any health insurance coverage purchased from an insurance company licensed under State law. For taxable years beginning after December 31, 2013, the credit is available only for health insurance purchased through an Affordable Insurance Exchange and only for a maximum coverage period of two additional consecutive taxable years, beginning with the first year in which the employer or any predecessor first offers any qualified plans to its employees through an Exchange.

For-profit firms may claim the tax credit as a general business credit and may carry the credit back for one year and carry the credit forward for 20 years. The credit is available for tax liability under the alternative minimum tax. For tax-exempt organizations, the credit is refundable and is capped at the amount of income tax withholding for employees and both the employee and employer portion of the health insurance (Medicare) payroll tax.

A qualified employer is an employer with no more than 25 full-time equivalent employees during the taxable year and whose employees have annual full-time equivalent wages that average no more than $50,000 (indexed beginning 2014).

During 2010 through 2013, the maximum credit is 35 percent (25 percent for tax-exempt employers) of the employer's contributions to the premium. For 2014 and later years, the maximum credit percentage is 50 percent (35 percent for tax-exempts). Eligible employer contributions are limited by the amount the employer would have contributed under the State average premium. For example, an employer located in Virginia paying for 60 percent of a single plan costing $5,500 per year could claim no more than 60 percent of Virginia's average premium of $4,890 in qualified employer contributions for purposes of calculating the credit.

The credit is phased out on a sliding scale between 10 and 25 full-time equivalent employees as well as between an average annual wage of $25,000 (indexed) and $50,000 (indexed). Because the reductions are additive, an employer with fewer than 25 full-time employees paying an average wage less than $50,000 might not be eligible for any tax credit. For example, an employer with 18 full-time equivalent employees and an average annual wage of $37,500 would have its credit reduced first by slightly more than half for the phase-out based on the number of employees and then by an additional half for the phase-out based on the average wage, thereby eliminating the entire credit.

Reasons for Change

Expanding eligibility for the credit and simplifying its operation would increase the utilization of the tax credit, and encourage more small employers to provide health benefits to employees and their families. The credit also provides an incentive for small employers to join an Exchange, thereby broadening the risk-pool.

The current law denial of the credit to otherwise eligible small employers due to the additive nature of the credit phase-outs may be perceived to be unfair. In addition, the uniform contribution requirement and the State premium contribution limit add complexity and may discourage some small employers from taking advantage of the credit.

Proposal

The proposal would expand the group of employers who are eligible for the credit to include employers with up to 50 full-time equivalent employees and would begin the phase-out at 20 full-time equivalent employees. In addition, there would be a change in the coordination of the phase-outs based on average wage and the number of employees (using a formula that is multiplicative rather than additive) so as to provide a more gradual combined phase-out. As a result, the proposal would ensure that employers with fewer than 50 employees and an average wage less than $50,000 would be eligible for the credit, even if they are nearing the end of both phase-outs. The proposal would also eliminate the requirement that an employer make a uniform contribution on behalf of each employee (although applicable nondiscrimination laws will still apply), and would eliminate the limit imposed by the State average premium.

The proposal would be effective for taxable years beginning after December 31, 2011.

INCENTIVES TO PROMOTE REGIONAL GROWTH

EXTEND AND MODIFY THE NEW MARKETS TAX CREDIT (NMTC)

Current Law

The NMTC is a 39-percent credit for qualified equity investments (QEIs) made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE) that is held for a period of seven years. The allowable credit amount for any given year is the applicable percentage (5 percent for the year the equity interest is purchased from the CDE and for each of the two subsequent years, and 6 percent for each of the following four years) of the amount paid to the CDE for the investment at its original issue. The NMTC is available for a taxable year to the taxpayer who holds the QEI on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

Under current law, the NMTC can be used to offset regular federal income tax liability but cannot be used to offset alternative minimum tax (AMT) liability.

The NMTC expired on December 31, 2011.

Reasons for Change

Reinstatement of the NMTC would allow CDEs to continue to generate investments in low-income communities.

Proposal

The proposal would authorize two more rounds of NMTC allocations (for 2012 and 2013), with an allocation amount of $5 billion for each round. The Administration estimates that within this $10 billion, at least $500 million ($250 million per year) will support financing healthy food options in distressed communities as part of the Healthy Food Financing Initiative. The proposal also would permit NMTC amounts resulting from QEIs made after December 31, 2011, to offset AMT liability.

The proposal would be effective upon enactment.

DESIGNATE GROWTH ZONES

Current Law

The Internal Revenue Code contains various incentives targeted to encourage the development of particular geographic regions, including empowerment zones and the Gulf Opportunity (GO) Zone. In addition, qualifying investment placed in service in 2011 and 2012 is eligible for additional first-year depreciation of the adjusted basis of the property.

Empowerment Zones

There are 40 empowerment zones—30 in urban areas and 10 in rural areas—that were designated through a competitive application process in three separate rounds in 1994, 1998, and 2002.[1] State and local governments nominated distressed geographic areas, which were selected on the strength of their strategic plans for economic and social revitalization. The urban areas were designated by the Secretary of Housing and Urban Development. The rural areas were designated by the Secretary of Agriculture. Empowerment zone designation remained in effect through December 31, 2011.

Incentives for businesses in empowerment zones include (1) a 20-percent wage credit for qualifying wages, (2) additional expensing for qualified zone property, (3) tax-exempt financing for certain qualifying zone facilities, (4) deferral of capital gains on sales and reinvestment in empowerment zone assets, and (5) exclusion of 60 percent (rather than 50 percent) of the gain on the sale of qualified small business stock held more than 5 years.[2]

The wage credit provides a 20-percent subsidy on the first $15,000 of annual wages paid to residents of empowerment zones by businesses located in these communities, if substantially all of the employee's services are performed within the zone. The credit is not available for wages taken into account in determining the work opportunity tax credit (WOTC).

To be eligible for the capital incentives, businesses must generally satisfy the requirements of an enterprise zone business. Among other conditions, these requirements stipulate that at least 50 percent of the total gross income of such business is derived from the active conduct of a business within an empowerment zone, a substantial portion of the use of tangible property of such business is within an empowerment zone, and at least 35 percent of its employees are residents of an empowerment zone.

[1] In addition, the District of Columbia Enterprise Zone (DC Zone) was established in 1998 and receives similar tax benefits to empowerment zones. The primary differences are that the eligibility rules are more generous for the DC Zone, the capital gains preferences are in the form of a full exclusion from income on the gain from qualified DC Zone assets held more than 5 years, and a homebuyer credit is provided to first-time homebuyers within DC. DC Zone status remained in effect through December 31, 2011.

[2] For qualified small business stock acquired after September 27, 2010 and before January 1, 2012, the exclusion percentage increases to 100 percent. This provision (100 percent exclusion) applies to all qualified small business stock, not just that issued by enterprise zone businesses.

Enterprise zone businesses are allowed to expense the cost of certain qualified zone property (which, among other requirements, must be used in the active conduct of a qualified business in an empowerment zone) up to an additional $35,000 above the amounts generally available under section 179. In addition, only 50 percent of the cost of such qualified zone property counts toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

Qualified enterprise zone businesses are eligible to apply for tax-exempt financing (empowerment zone facility bonds) for qualified zone property. These empowerment zone facility bonds do not count against state private activity bond limits; instead a limit is placed upon each zone, depending on population and whether the zone is in an urban or rural area.

In addition, residents of empowerment zones aged 18-39 years old qualify as a targeted group for the WOTC. Employers who hire an individual in a targeted group receive a 40 percent credit that applies to the first $6,000 of qualified first-year wages. Empowerment zone residents aged 16-17 can also qualify as a targeted group for WOTC, but the qualifying wage limit is reduced to $3,000 and the period of employment must be between May 1 and September 15.

GO Zone

The GO Zone is the portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina in 2005. Numerous tax incentives were provided to encourage the redevelopment of the areas within the GO zone, most of which have expired. Provisions in effect through 2011 include an increase in available tax-exempt bond financing, an increase in the rehabilitation credit rate for structures located in the GO Zone, and an additional first-year depreciation deduction for qualified property described below.

An additional first-year depreciation deduction is allowed for specified GO Zone extension property placed in service prior to January 1, 2012. The deduction equals 50 percent of the cost of qualified property. Specified GO Zone extension property is defined as property substantially all the use of which is in one or more specified portions of the GO Zone. Qualifying property must either be (1) nonresidential real property or residential rental property, or (2) in the case of a taxpayer who places in service a building described in (1), tangible personal property contained in the building as described in section 168(k)(2)(A)(i), if substantially all the use of such property is in such building and such property is placed in service within 90 days of the date the building is placed in service. The specified portions of the GO Zone are defined as those portions of the GO Zone which are identified by the Secretary of the Treasury as being in a county or parish in which hurricanes occurring in 2005 damaged more than 60 percent of the occupied housing units in such county or parish.

Bonus Depreciation

An additional first-year depreciation deduction is allowed for qualified property placed in service during 2011 and 2012. The deduction equals 100 percent of the cost of qualified property placed in service in 2011 and 50 percent of the cost of qualified property placed in service in 2012, and is allowed for both regular tax and alternative minimum tax purposes. The property's depreciable basis is adjusted to reflect this additional deduction. However, the taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

Qualified property for this purpose includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property. Qualified property must be new property, and excludes property that is required to be depreciated under the alternative depreciation system (ADS). To qualify for the 50 percent additional first-year depreciation deduction, property must be (1) acquired after December 31, 2007, and before January 1, 2013 (but only if no written binding contract for the acquisition was in effect before January 1, 2008), or (2) acquired pursuant to a written binding contract entered into after December 31, 2007, and before January 1, 2013. In general, the property must be placed in service by January 1, 2013. If property is self-constructed, the taxpayer must begin manufacture or construction of the property after December 31, 2007, and before January 1, 2013. To qualify for the 100 percent additional first-year deduction, the property must be acquired after September 8, 2010, and before January 1, 2012, and placed in service before January 1, 2012. An extension by one year of the placed-in-service date is allowed for certain property with a recovery period of ten years or longer and certain transportation property, if the property has an estimated production period exceeding one year and a cost exceeding $1 million. Certain aircraft not used in providing transportation services are also granted a one-year extension of the placed-in-service deadline. In these cases, the additional allowance applies only to adjusted basis attributable to manufacture or construction occurring before January 1, 2013. Special rules apply to syndications, sale-leasebacks, and transfers to related parties of qualified property.

Corporations otherwise eligible for additional first-year depreciation may elect to claim additional research or minimum tax credits in lieu of claiming additional depreciation for "eligible qualified property." Such property only includes otherwise qualified property that was acquired after March 31, 2008, but only taking into account adjusted basis attributable to the manufacture or construction of the property either (1) after March 31, 2008, and before January 1, 2010, or (2) after December 31, 2010, and before January 1, 2013. Only additional minimum tax credits may be taken with respect to property qualifying under (2). Depreciation for eligible qualified property must be computed using the straight-line method.

<u>Reasons for Change</u>

Growth zones would promote job creation and investment in economically distressed areas that have demonstrated potential for future growth and diversification into new industries. While current law provides regionally targeted benefits to numerous areas, these incentives are due to expire soon and some of these designations have been in effect over 17 years. The Administration desires to target resources to areas where they would provide the most benefit on a going-forward basis. In particular, the national competition for growth zone status would encourage such areas to develop rigorous plans for economic growth that connect the zone to drivers of regional economic growth. The targeted tax incentives provided to the zone would encourage private sector investment and other forms of increased economic activity in these areas. The current tax incentives are perceived as complex and difficult for businesses to navigate, potentially reducing the take-up rate for these incentives.

Proposal

The Administration proposes to designate 20 growth zones (14 in urban areas and 6 in rural areas). The zone designation and corresponding tax incentives would be in effect from January 1, 2014 through December 31, 2018. The Secretary of Commerce would select the zones in consultation with the Secretary of Housing and Urban Development and the Secretary of Agriculture.

The zones would be chosen through a competitive application process. A State, county, city, or other general purpose political subdivision of a State or possession (a "local government"), or an Indian tribal government would be eligible to nominate an area for growth zone status. Areas could be nominated by more than one local government, if the nominated area is within the jurisdiction of more than one local government or State. In addition, local governments within a region could join together to jointly nominate multiple areas for growth zone status, so long as each designated zone independently satisfies the eligibility criteria. To be eligible to be nominated, an area must satisfy the following criteria:

1. A nominated area would have to have a continuous boundary (that is, an area must be a single area; it cannot be comprised of two or more separate areas) and could not exceed 20 square miles if an urban area or 1,000 square miles if a rural area.

2. A nominated urban area would have to include a portion of at least one local government jurisdiction with a population of at least 50,000. The population of a nominated urban area could not exceed the lesser of: (1) 200,000; or (2) the greater of 50,000 or 10 percent of the population of the most populous city in the nominated area. A nominated rural area could not have a population that exceeded 30,000.

Nominated areas would be designated as growth zones based on the strength of the applicant's "competitiveness plan" and its need to attract investment and jobs. Communities would be encouraged to develop a strategic plan to build on their economic strengths and outline targeted investments to develop their competitive advantages. Collaboration across a wide range of stakeholders would be useful in developing a coherent and comprehensive strategic plan. A successful plan would clearly outline how the economic strategy would connect the zone to drivers of regional economic growth.

In evaluating applications, the Secretary of Commerce could consider other factors, including: unemployment rates, poverty rates, household income, home-ownership, labor force participation and educational attainment. In addition, the Secretary may set minimal standards for the levels of unemployment and poverty that must be satisfied by the nominated area.

"Rural area" would be defined as any area that is (1) outside of a metropolitan statistical area (within the meaning of section 143(k)(2)(B)), or (2) determined by the Secretary of Commerce, after consultation with the Secretary of Agriculture, to be a rural area. "Urban area" would be defined as any area that is not a rural area.

Two tax incentives would be applicable to growth zones. First, an employment credit would be provided to businesses that employ zone residents. The credit would apply to the first $15,000 of qualifying zone employee wages. The credit rate would be 20 percent for zone residents who are employed within the zone and 10 percent for zone residents employed outside of the zone. The definition of a qualified zone employee would follow rules found in section 1396(d). For the purposes of the 10 percent credit, the requirement that substantially all of the services performed by the employee for the employer are within the zone would not apply. The definition of qualified zone wages would follow the definitions provided in section 1396(c) and 1397(a).

Second, qualified property placed in service within the zone would be eligible for additional first-year depreciation of 100 percent of the adjusted basis of the property. Qualified property for this purpose includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property. Qualified property must be new property. Qualified property excludes property that is required to be depreciated under the ADS. The taxpayer must purchase (or begin the manufacture or construction of) the property after the date of zone designation and before January 1, 2019 (but only if no written binding contract for the acquisition was in effect before zone designation). The property must be placed in service within the zone before January 1, 2019.

The Secretary of the Treasury would be given authority to collect data from taxpayers on the use of such tax incentives by zone. The Secretary of Commerce may require the nominating local government to provide other data on the economic conditions in the zones both before and after designation. These data would be used to evaluate the effectiveness of the growth zones program.

RESTRUCTURE ASSISTANCE TO NEW YORK CITY, PROVIDE TAX INCENTIVES FOR TRANSPORTATION INFRASTRUCTURE

Current Law

The Job Creation and Worker Assistance Act of 2002 (the Act) provided tax incentives for the area of New York City damaged or affected by the terrorist attacks on September 11, 2001. The Act created the "New York Liberty Zone," defined as the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. New York Liberty Zone tax incentives included: (1) an expansion of the work opportunity tax credit (WOTC) for New York Liberty Zone business employees; (2) a special depreciation allowance for qualified New York Liberty Zone property; (3) a five-year recovery period for depreciation of qualified New York Liberty Zone leasehold improvement property; (4) $8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property; (5) $9 billion of additional tax-exempt, advance refunding bonds; (6) increased section 179 expensing; and (7) an extension of the replacement period for nonrecognition of gain for certain involuntary conversions.[3]

The expanded WOTC credit provided a 40-percent subsidy on the first $6,000 of annual wages paid to New York Liberty Zone business employees for work performed during 2002 or 2003.

The special depreciation allowance for qualified New York Liberty Zone property equals 30 percent of the adjusted basis of the property for the taxable year in which the property was placed in service. Qualified nonresidential real property and residential rental property must have been purchased by the taxpayer after September 10, 2001, and placed in service before January 1, 2010. Such property is qualified property only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the September 11, 2001, terrorist attacks.[4]

The five-year recovery period for qualified leasehold improvement property applied, in general, to buildings located in the New York Liberty Zone if the improvement was placed in service after September 10, 2001, and before January 1, 2007, and no written binding contract for the improvement was in effect before September 11, 2001.

The $8 billion of tax-exempt private activity bond financing is authorized to be issued by the State of New York or any political subdivision thereof after March 9, 2002, and before January 1, 2012.

The $9 billion of additional tax-exempt, advance refunding bonds was available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

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[3] The Working Families Tax Relief Act of 2004 amended certain New York Liberty Zone provisions relating to tax-exempt bonds.

[4] Other qualified property must have been placed in service prior to January 1, 2007.

Businesses were allowed to expense the cost of certain qualified New York Liberty Zone property placed in service prior to 2007, up to an additional $35,000 above the amounts generally available under section 179. In addition, only 50 percent of the cost of such qualified New York Liberty Zone property counted toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the replacement period) property similar or related in service or use. In general, the replacement period begins with the date of the disposition of the converted property and ends two years (three years if the converted property is real property held for the productive use in a trade or business or for investment) after the close of the first taxable year in which any part of the gain upon conversion is realized. The Act extended the replacement period to five years for property in the New York Liberty Zone that was involuntarily converted as a result of the terrorist attacks on September 11, 2001, if substantially all of the use of the replacement property is in New York City.

Reasons for Change

Some of the tax benefits that were provided to New York following the attacks of September 11, 2001, likely will not be usable in the form in which they were originally provided. State and local officials in New York have concluded that improvements to transportation infrastructure and connectivity in the Liberty Zone would have a greater impact on recovery and continued development than would continuing some of the original tax incentives.

Proposal

The proposal would provide tax credits to New York State and New York City for expenditures relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. New York State and New York City each would be eligible for a tax credit for expenditures relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. The tax credit would be allowed in each year from 2013 to 2022, inclusive, subject to an annual limit of $200 million (for a total of $2 billion in tax credits), and would be divided evenly between the State and the City. Any unused credits below the annual limit would be added to the $200 million annual limit for the following year, including years after 2022. Similarly, expenditures that exceed the annual limit would be carried forward and subtracted from the annual limit in the following year. The credit would be allowed against any payments (other than payments of excise taxes and social security and Medicare payroll taxes) made by the City and State under any provision of the Code, including income tax withholding. The Treasury Department would prescribe such rules as are necessary to ensure that the expenditures are made for the intended purposes. The amount of the credit received would be considered State and local funds for the purpose of any Federal program.

The proposal would be effective after December 31, 2012.

MODIFY TAX-EXEMPT BONDS FOR INDIAN TRIBAL GOVERNMENTS

Current Law

In general, Section 7871(c) limits Indian tribal governments in their use of tax-exempt bonds to the financing of "essential governmental function" activities that are "customarily" performed by State and local governments with general taxing powers. In addition, outside the limited authorization for Tribal Economic Development Bonds, Section 7871(c)(2) generally prohibits Indian tribal governments from issuing tax-exempt private activity bonds, except in narrow circumstances to finance manufacturing facilities subject to restrictions.

The American Recovery and Reinvestment Act of 2009 ("ARRA") provided $2 billion in bond authority for a new category of tax-exempt bonds for Indian tribal governments, known as "Tribal Economic Development Bonds" under Section 7871(f) of the Code. This bond provision provides Indian tribal governments more flexibility to finance economic development projects than is allowable under the existing essential governmental function standard. This bond provision generally allows Indian tribal governments to use tax-exempt bond financing under more flexible standards that are comparable to those applied to States and local governments in their use of tax-exempt bonds under Section 103 (subject to express targeting restrictions on Tribal Economic Development Bonds that require financed projects to be located on Indian reservations and that prohibit the financing of certain gaming facilities). For State and local governments, a more flexible two-part standard under Section 141 generally allows use of tax-exempt "governmental bonds" (as distinguished from "private activity bonds") if either: (1) the issuer uses at least 90 percent of the bond proceeds for State or local governmental use (as contrasted with private business use); or (2) the debt service on at least 90 percent of the bond proceeds is payable from or secured by payments or property used for State or local governmental use.

ARRA also included a directive to the Treasury Department to study the Tribal Economic Development Bond provision and to report to Congress on the results of this study, including recommendations regarding this provision. The legislative history of ARRA indicated that Congress sought recommendations on whether to "eliminate or otherwise modify" the essential governmental function standard for Indian tribal tax-exempt bond financing.

Reasons for Change

The Treasury Department recently submitted its report to Congress regarding recommendations on the Tribal Economic Development Bond provision. This proposal incorporates the recommendations from this report. For further background and analysis on these recommendations, see this Treasury Department report, which is available at http://www.treasury.gov/resource-center/tax-policy/Documents/Tribal-Economic-Development-Bond-Provision-under-Section-7871-of-IRC-12-19-11.pdf.

For State and local governments, the applicable two-part private business restriction standard for tax-exempt governmental bonds (as distinguished from private activity bonds) under Section 141 involves established, well-known, and administrable tax standards. The private business use limitation particularly involves workable tax standards using general tax principles that focus on ownership, leasing, and contractual rights. These standards focus eligibility for governmental bonds on the nature of the beneficiaries of the tax-exempt financing (rather than on the nature of the activities financed).

By contrast, for Indian tribal governments, the essential governmental function standard focuses on appropriate governmental activities (rather than the actual beneficiaries) and has proven to be a difficult standard to define and to administer. The analogous essential governmental function standard under Section 115 is vague. Moreover, the custom-based limitation on this standard has proven to be particularly unworkable, based on difficulties in determining customs, the subjective nature of customs, the evolving nature of customs over time, the differing nature of customs among diverse State and local governmental entities, and the increasing involvement of State and local governments in quasi-commercial activities.

Although the Indian Tribal Government Tax Status Act of 1982 sought to provide tax parity between Indian tribal governments and State and local governments, the existing framework for eligibility for tax-exempt bond financing for State and local governments, on one hand, and Indian tribal governments, on the other hand, reflects fundamentally different analytic standards. Application of the different analytic standards resulted in different outcomes and perceived unfairness.

The Treasury Department believes that goals of tax parity, fairness, flexibility, and administrability warrant the provision of a tax-exempt bond program framework for Indian tribal governments that uses standards that are comparable to those used for State and local governments, with tailored modifications.

Proposal

1. Adopt for Indian Tribal Governments the Comparable State or Local Government Standard of Eligibility for Issuing Tax-exempt Governmental Bonds on a Permanent Basis. The proposal would adopt the State or local government standard for tax-exempt governmental bonds under Section 141 without a bond volume cap on such governmental bonds (subject to restrictions discussed below). This standard is generally embodied in the limited authorization for Tribal Economic Development Bonds under Section 7871(f) for purposes of Indian tribal governmental eligibility to issue tax-exempt governmental bonds. The proposal would repeal the existing essential governmental function standard for Indian tribal governmental tax-exempt bond financing under Section 7871(c).

2. Adopt a Comparable Private Activity Bond Standard. The proposal would allow Indian tribal governments to issue tax-exempt private activity bonds for the same types of projects and activities as are allowed for State and local governments under Section 141(e), under a national bond volume cap. The same volume cap exceptions as those for State and local governments would apply in addition to the bonds being subject restrictions discussed below The proposal would employ a tailored version of a comparable annual tax-exempt private activity bond volume cap for Indian tribal governments. This tailored national Tribal private activity bond volume cap for all Indian tribal governments together as a group would be in an amount equal to the greater of: (i) a total national Indian tribal population-based measure determined under Section 146(d)(1)(A)

(applied by using such national Indian tribal population in lieu of State population), or (ii) the minimum small population-based State amount under Section 146(d)(1)(B). The proposal would delegate to the Treasury Department the responsibility to allocate that national bond volume cap among Indian tribal governments.

3. Project Location Restriction. The proposal would impose a targeting restriction on the location of projects financed with tax-exempt bonds issued or used by Indian tribal governments that is similar to the restriction under Section 7871(f)(3)(B)(ii), which requires that projects financed with Tribal Economic Development Bonds be located on Indian reservations. The proposal would provide some additional flexibility with respect to this project location restriction. The proposal would allow Indian tribal governments to issue or use tax-exempt bonds to finance projects that are located on Indian reservations, together with projects that both: (1) are contiguous to, within reasonable proximity of, or have a substantial connection to an Indian reservation; and (2) provide goods or services to resident populations of Indian reservations.

4. Gambling Facility Restriction. For policy reasons, the proposal would impose a targeting restriction on tax-exempt bonds issued or used by Indian tribal governments generally that incorporates the existing targeting restriction under Section 7871(f)(3)(B)(i) which presently prohibits use of proceeds of Tribal Economic Development Bonds to finance certain gaming projects.

This proposal would be effective as of the date of enactment.

ALLOW CURRENT REFUNDINGS OF STATE AND LOCAL GOVERNMENTAL BONDS

Current Law

The Code provides Federal tax subsidies for lower borrowing costs on debt obligations issued by States and local governments and political subdivisions thereof ("State and local bonds"). The Code delivers Federal borrowing subsidies to State and local governments in different ways. Section 103 provides generally for the issuance of tax-exempt bonds for eligible governmental purposes at lower borrowing costs based on the excludability of the interest paid on the bonds from the gross income of the owners of the bonds. Other State or local bond provisions provide Federal borrowing subsidies to State and local governments through direct subsidy payments (called "refundable tax credits") to State and local governmental issuers, tax credits to investors in certain tax credit bonds to replace specified portions of the interest on those bonds, and other collateral tax advantages to State and local bonds.

From time to time, for reasons associated with Federal cost considerations and other targeting objectives, various State and local bond provisions have had bond volume caps, time deadlines for bond issuance, or transitional provisions for program restrictions. For example, Section 54AA enacted by the American Recovery and Reinvestment Act of 2009 ("ARRA") authorized the issuance of taxable Build America Bonds in 2009 and 2010 for governmental capital projects and provided for direct borrowing subsidy payments to issuers for 35 percent of the borrowing costs. In addition, Section 54A authorizes the issuance of certain Qualified Tax Credit Bonds for targeted public school and energy programs under specified bond volume caps and within certain time periods. Other recent examples of targeted, temporary bond provisions include a $25 billion authorization for "Recovery Zone Bonds" in Section 1400U1-3; a temporary exception to the alternative minimum tax preference for interest on tax-exempt private activity bonds under Section 57(a)(5); and a temporary increase in the size of a small issuer exception (from $10 million to $30 million) to the tax-exempt carrying cost disallowance rule for financial institutions in Section 265(b).

In the tax-exempt bond area, a "current refunding" or "current refunding issue" (under Treas. Reg. §1.150-1(d)(3)) refers to bonds used to refinance prior bonds in circumstances in which the prior bonds are redeemed or retired within 90 days after issuance of the current refunding bonds.

Reasons for Change

Tax policy favors current refundings of State and local bonds within appropriate size and maturity parameters because these current refundings generally reduce both: (a) borrowing costs for State and local governmental issuers; and (b) Federal revenue costs or tax expenditure costs of Federal subsidies for borrowing costs on State and local bonds. The primary reason that States and local governments engage in current refunding transactions is to reduce interest costs.[5]

[5] By comparison, an "advance refunding" refers to a refinancing in which the refunding bonds and the prior bonds may remain outstanding concurrently for more than 90 days. Advance refundings involve duplicative Federal subsidy costs for the same financed project or purpose. Section 149(d) restricts advance refundings.

The extent to which statutory provisions address current refundings has varied among different State and local bond program provisions. Selected examples of provisions that address current refundings include the following: Section 1313(a) of the Tax Reform Act of 1986 (general transition rule); Section 147(b) (private activity bond volume cap); Section 142(i)(9) (bond volume cap for qualified green buildings and sustainable design projects); Section 142(m)(4) (bond volume cap for qualified highway or surface freight transfer projects); and Section 1394(f)(3)(C)(ii) (bond volume cap for new empowerment zone facility bonds). By contrast, other State and local bond programs do not address current refundings expressly. Selected recent examples of provisions that do not address current refundings expressly include Build America Bonds under Section 54AA, Qualified Tax Credit Bonds under Section 54A, and Recovery Zone Bonds under Section 1400U1-3.

In light of the disparate statutory treatment of current refundings and the lack of express consideration of current refundings in certain statutory provisions, a general statutory provision that sets forth parameters for allowable current refundings of State and local bonds would promote greater uniformity and tax certainty.

Proposal

The proposal would provide a general Code provision to authorize current refundings of State or local bonds upon satisfaction of the following requirements:

1. Size Limit. The issue price of the current refunding bonds would be required to be no greater than the outstanding principal amount (generally meaning the outstanding stated principal amount, except as provided below) of the refunded bonds. For bonds issued with more than a de minimis amount of original issue discount or premium, the adjusted issue price or accreted present value of the refunded bonds would be required to be used as the measure of this size limitation in lieu of the outstanding stated principal amount of the refunded bonds.

2 Maturity Limit. The weighted average maturity of the current refunding bonds would be required to be no longer than the remaining weighted average maturity of the refunded bonds (determined in the manner provided in Section 147(b)).

This provision would apply generally to State and local bond programs or provisions that do not otherwise allow current refundings or expressly address the treatment of current refundings (including bonds for which bond volume caps or time deadlines applied to issuance of original bonds). This provision would be inapplicable to State and local bond programs or provisions that otherwise allow or expressly address current refundings, such as traditional tax-exempt governmental bonds under Section 103 for which current refundings generally are allowable without statutory bond maturity restrictions and qualified tax-exempt private activity bonds under Section 141(e) for which current refundings generally are allowable within prescribed statutory bond maturity restrictions under Section 147(b).

This proposal would be effective as of the date of enactment.

Reform and Expand the Low-Income Housing Tax Credit (LIHTC)

ENCOURAGE MIXED INCOME OCCUPANCY BY ALLOWING LIHTC-SUPPORTED PROJECTS TO ELECT A CRITERION EMPLOYING A RESTRICTION ON AVERAGE INCOME

Current Law

In order for a building to qualify for the LIHTC, a minimum portion of the units in the building must be rent restricted and occupied by low-income tenants. Under section 42(g)(1), the taxpayer makes an irrevocable election between two criteria. Either—

- At least 20 percent of the units must be rent restricted and occupied by tenants with income at or below 50 percent of area median income (AMI); or

- At least 40 percent of the units must be rent restricted and occupied by tenants with incomes at or below 60 percent of AMI.

In all cases, qualifying income standards are adjusted for family size. The amount of the credit reflects the fraction of the building's eligible basis that is attributable to the low-income units. Maximum allowable rents are restricted to 30 percent of the elected income standard, adjusted for the number of bedrooms in the unit.

Reasons for Change

In practice, these criteria often produce buildings that serve a very narrow income band of tenants—those just below the top of the eligible income range. For example, if the rent-restricted units in the building must be occupied by tenants at or below 60 percent of AMI, these units may end up being occupied by tenants with incomes that fall between 40 percent and 60 percent of AMI. As a result, the income criteria do not include incentives to create mixed-income housing, and LIHTC-supported buildings may not be able to serve those most in need. Mixed-income buildings are especially important in low-income communities that are being revitalized and in sparsely populated rural areas. In addition, the inflexibility of the income criteria makes it difficult for LIHTC to support acquisition of partially or fully occupied properties for preservation or repurposing.

Proposal

The proposal would add a third criterion to the two described above. When a taxpayer elects this criterion, at least 40 percent of the units in the project would have to be occupied by tenants with incomes that *average* no more than 60 percent of AMI. No rent-restricted unit, however, could be occupied by a tenant with income over 80 percent of AMI; and, for purposes of computing the average, any unit with an income limit that is less than 20 percent of AMI would be treated as having a 20-percent limit. Maximum allowable rents would be determined according to the income limit of the unit.

For example, suppose that a project has 70 identical rent-restricted units—10 units with income limits of 20 percent of AMI, 10 with limits of 40 percent of AMI, 20 with limits of 60 percent of AMI, and 30 with limits of 80 percent of AMI. This would satisfy the new criterion because none of the limits exceeds 80 percent of AMI and the average does not exceed 60 percent of AMI. ($10 \times 20 + 10 \times 40 + 20 \times 60 + 30 \times 80 = 4200$, and $4200/70 = 60$.)

A special rule would apply to rehabilitation projects that contain units that receive ongoing subsidies (e.g., rental assistance, operating subsidies, and interest subsidies) administered by the U.S. Department of Housing and Urban Development or the U.S. Department of Agriculture. If a tenant, when admitted to such a property, had an income not more than 60 percent of the then-applicable Area Median Income and if, when the tenant's income is measured for purposes of LIHTC qualification, the tenant's income is greater than 60 percent of the now-applicable Area Median Income (AMI) but not more than 80 percent of AMI (this fraction is called the "Credit-Year-1 AMI Percentage"), then, the taxpayer may make an election that would allow the tenant to remain in residence without impairing the building's LIHTCs. In particular, the election would have the following consequences—

- The average-income criterion would be applied without taking that tenant's unit into account;

- The requirement in the next-available-unit rule, *see* section 42(g)(2)(D)(ii), would apply; and

- The tenant's unit would be treated as rent restricted if the gross rent collected from the unit does not exceed 30 percent of the Credit-Year-1 AMI Percentage times current AMI.

When the tenant moves out, if the unit is to continue to be rent-restricted, the income restriction on the unit would revert to 60 percent of AMI (or whatever other level the taxpayer determines, consistent with the criterion that was elected under section 42(g)(1)).

The proposal would be effective for elections under section 42(g)(1) that are made after the date of enactment.

MAKE THE LOW INCOME HOUSING TAX CREDIT (LIHTC) BENEFICIAL TO REAL ESTATE INVESTMENT TRUSTS (REITS)

Current Law

Real estate investment trusts (REITs) and regulated investment companies (RICs) receive no benefit from becoming entitled to a general business credit under section 38, such as the low-income housing tax credit (LIHTC). Like other financial intermediaries, REITs and RICs are efficient investment vehicles only if they and their investors together incur only a single level of tax on the income from the REITs' or RICs' investments. The Code achieves this result by allowing REITs and RICs a deduction for dividends paid (the DPD). Qualification requirements and an excise tax cause REITs and RICs to pay dividends of substantially all of their pre-DPD net income. In addition, the Code enables each REIT or RIC exactly to zero out its taxable income for the year by paying post-taxable-year-end dividends that the REIT or RIC may nevertheless deduct as if the dividends had been paid during the taxable year. A REIT or RIC that zeroes out its taxable income has no tax liability against which to use a tax credit.

Moreover, their shareholders would receive no benefit from REITs' or RICs' receiving those credits. REITs and RICs are C corporations. That is, unlike trusts, partnerships, and S corporations, they generally do not directly pass through tax items to their owners. A significant number of REIT shares are held by RICs.

The LIHTC provision in the Code encourages construction and major rehabilitation of affordable housing for low-income residents. A taxpayer is eligible to receive LIHTCs only after receiving an allocation either of credits or of tax-exempt volume cap from an appropriate State agency. In almost all financial climates, there are not enough allocations to satisfy all applicants. Although the credits that make up the general business credit are not transferable, in many cases—including LIHTCs—there is, in effect, a "market" for the credits. The value of the credits in this market is reflected in the amount of equity that the credit can attract to the activity that Congress wanted to encourage when it created the credit.

Reasons for Change

The effectiveness of LIHTCs in increasing the construction and preservation of affordable housing would be enhanced if there were more demand for these credits. For example, during the recent economic crisis, there was a sharp drop in the amount that investors were willing to invest for each dollar of LIHTC acquired. If REIT shareholders could benefit from any LIHTCs that REITs receive, there would be an increase in demand.

Proposal

The proposal would permit a REIT that receives LIHTCs to designate as tax exempt some of the dividends that it distributes. Dividends so designated would be excluded from the gross income of the shareholders that receive them. The amount so designated could not exceed the quotient of the REIT's LIHTCs for the year, divided by the highest corporate tax rate in section 11(b) of the Code. If there is insufficient E&P to pay this amount of dividends, the unused authority to designate tax-exempt dividends could be carried forward indefinitely. Also, if a REIT or RIC is a shareholder that receives these tax-exempt dividends, the recipient could designate as exempt a corresponding amount of dividends that it distributes. In the case of any compliance failure, the REIT would be responsible for recapture under section 42(j) as if it had used the credit to reduce its own tax liability. Under the proposal, the passive-loss and at-risk rules would not apply to the receipt of the exempt dividends.

The proposal would be effective for taxable years of a REIT that end after the date of enactment.

PROVIDE 30-PERCENT BASIS "BOOST" TO PROPERTIES THAT RECEIVE AN ALLOCATION OF TAX-EXEMPT BOND VOLUME CAP AND THAT CONSUME THAT ALLOCATION

Current Law

A building owner may receive 70-percent-present-value LIHTCs (colloquially called "9-percent credits") if the State housing credit agency allocates the credits. Also a building owner may receive 30-percent-present-value LIHTCs (colloquially called "4-percent credits") if the building is at least 50-percent financed with tax-exempt bonds that are subject to the private activity bond volume cap.

In both cases, the annual credit received by the building owner is the product of the credit rate, times the qualified basis. The qualified basis for computing the LIHTC is a specified fraction (often 100 percent) of the eligible basis. Subject to certain adjustments and special rules, eligible basis is generally a building's adjusted basis. In some situations, however, there is an increase (a "basis boost") over the amount that would otherwise be eligible basis. There are three situations in which a building receives a basis boost: if it is located in a qualified census tract; if it is located in a difficult development area, as designated by the Secretary of Housing and Urban Development;[6] or if the State housing credit agency designates it as needing an enhanced credit in order to be financially feasible as part of a qualified low-income housing project.[7] In these situations, the eligible basis for the building may be up to 130 percent of what it would be in the absence of any such boost.

Reasons for Change

To obtain 30-percent-present-value LIHTCs, some developers finance their buildings with private activity bonds, despite the availability of other, taxable financing that the developers would prefer to use.

Preservation of existing affordable housing is acutely needed. Many tens of thousands of federally assisted housing units are being lost, in large part because of inability to fund necessary capital improvements. LIHTC-supported preservation offers the hope not only of protecting the existing Federal investment in affordable housing by leveraging private capital but also of gaining the benefits of private-market discipline for federally assisted properties. Moreover, preservation is a cost-effective alternative to new construction. The per-unit cost of preservation is about one quarter that of new construction, and it greatly reduces the financial and human costs of relocating tenants.

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[6] These two location-based basis boosts are available for buildings financed with tax-exempt bonds subject to the private-activity-bond volume cap as well as for buildings that benefit from LIHTCs that are allocated by State housing credit agencies.

[7] This basis boost is potentially available regardless of the location of the building. It is not available, however, for a building if any portion of the eligible basis of the building is financed by tax-exempt bonds subject to the private-activity-bond volume cap.

As currently structured, however, the LIHTC program does not attract sufficient equity capital to address preservation needs. Historically, the 70-percent-present-value credit has been oversubscribed, with proposals for new construction tending to beat out those for preservation. The 30-percent-present-value credit often fails to provide sufficient incentive to make preservation projects economically attractive.

Proposal

The proposal would provide two additional incentives for investment in preservation projects. First, there would be a more efficient way to qualify for 30-percent-present-value credits; second, there would be the possibility of an additional 30 percent "boost" to qualified basis (a "Federal-Investment-Protection Basis Boost").

To make a project eligible for these incentives, a State housing credit agency would give the project a "Federal-Investment-Protection Designation." This designation could be given only to projects that satisfy the following requirements:

- The project involves the preservation, recapitalization, and rehabilitation of existing housing;
- The project demonstrates a serious backlog of capital needs or deferred maintenance;
- The project involves housing that was previously financed with Federal funds or benefited from LIHTC; and
- Because of that Federal support, the housing was subject to a long-term use agreement limiting occupancy to low-income households.

(1) Alternative Qualification for 30-Percent-Present-Value Credits
Under the proposal, all buildings covered by a Federal-Investment-Protection Designation could benefit from the alternative qualification process. In lieu of becoming eligible for 30-percent-present-value credits in the manner provided in current law—that is, as a result of being at least 50-percent financed by tax-exempt bonds for which private-activity-bond volume cap (volume cap) has been allocated—a building could become eligible if—

- There is an allocation of volume cap in an amount not less than the amount of bonds that would be necessary to qualify for LIHTCs; and
- The volume cap so allocated reduces the State's remaining volume cap as if tax-exempt bonds had been issued.

(2) Basis "Boost" for Some Projects with a Federal-Investment-Protection Designation
Under the proposal, a Federal-Investment-Protection Basis Boost would be available to a limited number of projects that receive a Federal-Investment-Protection Designation and that are eligible for 30-percent-present-value credits—either as a result of having bond-financing or as a result of the alternative qualification. The proposal would also permit the State housing credit agency to

designate some or all of such a project's qualified basis for this new basis boost. A Federal-Investment-Protection Basis Boost could be used "on top of" any existing boost for being in a qualified census tract, for being in a difficult development area or for having received a "boost" designation by the State housing credit agency under current law. For example, if the entire qualified basis of a project in a difficult development area is designated for a Federal-Investment-Protection Basis Boost, its qualified basis would be 169 percent (130 percent × 130 percent) of what it would be otherwise.

The volume of Federal-Investment-Protection Basis Boosts that a State housing credit agency can make would be limited by an amount that is computed using the State's volume cap. Under the limitation, the aggregate amount of basis annually eligible for a Federal-Investment-Protection Basis Boost would be 0.8 percent of the State's volume cap for that calendar year. These amounts could be carried over for a period of up to 5 years. There would, however, be no carryover from any calendar year before the year that contains the date of enactment.

For example, suppose a State had volume cap that had carried over from 2011 and, in 2013, the State allocated that carried-over volume cap to enable the issuance in 2013 of tax-exempt bonds that financed a qualifying project. Suppose further that the State housing finance agency gave the project a Federal-Investment-Protection Designation and that the agency decided to designate qualifying basis of the project for a Federal-Investment-Protection Basis Boost. The aggregate qualified basis (from this and other projects) that the agency could designate for Federal-Investment-Protection Basis Boosts could not exceed 0.8 percent of the State's volume cap for 2013.

If at the end of 2012, an amount of potential basis boost was eligible to be carried over, then the aggregate qualified basis that the agency could designate for Federal-Investment-Protection Basis Boosts could not exceed the sum of the carryover amount at the end of 2012, plus 0.8 percent of the State's volume cap for 2013.

The proposal would be effective for projects that are allocated volume cap after the date of enactment. States' authorizations to designate basis for a Federal-Investment-Protection Basis Boost would begin with the calendar year containing the date of enactment.

REQUIRE LIHTC-SUPPORTED HOUSING TO PROVIDE APPROPRIATE PROTECTIONS TO VICTIMS OF DOMESTIC VIOLENCE

Current Law

Low-income housing tax credits (LIHTCs) support the construction and preservation of a large portion of the nation's affordable housing for people of limited means. To qualify for LIHTCs, a project must have a minimum fraction of its units that are rent restricted and occupied by low-income individuals (defined as being at or below certain percentages of area median income). (Units that are restricted with respect to the income of their occupants and the rents that can be charged for them are called "low-income" units.)

To ensure that low-income units remain low-income units for many decades, no LIHTCs are allowed with respect to any building for any taxable year unless an extended low income housing commitment (Long-Term Use Agreement, or Agreement) is in effect as of the end of the year. A Long-Term Use Agreement is a contract between the owner of the property and the applicable State housing credit agency. The Agreement must run with the land to bind future owners of the property for three decades or more and must be enforceable in State court not only by the State agency but also by any past, present, or future income-qualified tenant.

In addition to requiring that certain minimum portions of a building be low-income units, the Long-Term Use Agreement must mandate certain conduct in the management of the building—

- The Agreement must prohibit the refusal to lease to a holder of a voucher or certificate of eligibility under section 8 of the United States Housing Act of 1937 because of the status of a prospective tenant as such a holder; and

- With respect to any low-income unit, the Agreement must prohibit during the life of the Agreement and for three years after its termination—
  - Any increase in gross rent not otherwise permitted under section 42 of the Code; and
  - Any eviction or other termination of tenancy of any existing tenant (other than for good cause).

Credits are not available unless occupancy is available to the general public. Section 42(g)(9), however, clarifies that a project does not fail to meet this general public use requirement solely because of occupancy restrictions or preferences that favor tenants with special needs, tenants who are members of a specified group under certain Federal or State programs, or tenants who are involved in artistic or literary activities.

The Violence Against Women Act (42 USC chapter 136, subchapter III) currently protects tenants in certain Federal housing programs. Occupancy in a LIHTC-supported building, however, does not today result in any protection for victims of domestic violence, dating violence, sexual assault, stalking, or threats of any of these actions (collectively referred to in this document as "domestic abuse").

Reasons for Change

No building that has benefited from LIHTCs should fail to provide reasonable protections for victims of domestic abuse.

Proposal

Protections similar to those provided in the Violence Against Women Act would be required in all Long-Term Use Agreements. The protections would apply to both the low-income and the market-rate units in the building.

For example, once such an Agreement applies to a building, the owner could not refuse to rent any unit in the building to a person because that person had experienced domestic abuse. Moreover, any such experience of domestic abuse would not be good cause for terminating a tenant's occupancy. Under the Agreement, an owner could bifurcate a lease so that the owner could simultaneously (1) remove or evict a tenant or lawful occupant who engaged in criminal activity directly relating to domestic abuse and yet (2) avoid evicting, terminating, or otherwise penalizing a tenant or lawful occupant who is a victim of that criminal activity. The proposal would clarify that such a continuing occupant could become a tenant and would not have to be tested for low-income status as if the continuing occupant were a new tenant.

Any prospective, present, or former occupant of the building could enforce these provisions of an Agreement in any State court, whether or not that occupant meets the income limitations applicable to the building.

In addition, the proposal would clarify that occupancy restrictions or preferences that favor persons who have experienced domestic abuse would qualify for the "special needs" exception to the general public use requirement.

The proposal would be effective for Long-Term Use Agreements that are either first executed, or subsequently modified, on or after the date that is 30 days after enactment. The proposed clarification of the general public use requirement would be effective for taxable years ending after the date of enactment.

CONTINUE CERTAIN EXPIRING PROVISIONS THROUGH CALENDAR YEAR 2013

A number of temporary tax provisions that have been routinely extended have expired or are scheduled to expire on or before December 31, 2012. The Administration proposes to extend a number of these provisions through December 31, 2013. For example, the optional deduction for State and local general sales taxes; the deduction for qualified out-of-pocket classroom expenses; the deduction for qualified tuition and related expenses; the Subpart F "active financing" and "look-through" exceptions; the modified recovery period for qualified leasehold, restaurant, and retail improvements; and several trade agreements would be extended through December 31, 2013. Temporary incentives provided for the production of fossil fuels would be allowed to expire as scheduled under current law.

See Table 4 for a list of the provisions that the Administration proposes to extend.

UPPER-INCOME TAX PROVISIONS

Sunset the Bush Tax Cuts for Those with Income in Excess of $250,000 ($200,000 if Single)

REINSTATE THE LIMITATION ON ITEMIZED DEDUCTIONS FOR UPPER-INCOME TAXPAYERS

Current Law

Individual taxpayers may elect to itemize their deductions instead of claiming a standard deduction. Itemized deductions include medical and dental expenses (in excess of 7.5 percent of AGI), [8] State and local property taxes and income taxes,[9] interest paid, gifts to charities, casualty and theft losses (in excess of 10 percent of AGI), job expenses and certain miscellaneous expenses (some only in excess of 2 percent of AGI).

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Tax Act (EGTRRA) in 2001, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) were reduced by 3 percent of the amount by which AGI exceeded a statutory floor that was indexed annually for inflation, but not by more than 80 percent of the otherwise allowable deductions. EGTRRA temporarily eliminated the itemized deduction limitation and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) extended this tax relief for two years, through 2012. The baseline for this Budget assumes that relief from this limitation on itemized deductions as provided by EGTRRA and TRUIRJCA is made permanent.

For 2012, if it were applicable, the AGI floor for the limitation on itemized deductions would be $173,650 ($86,825 if married filing separately).

Reason for Change

Limiting the tax benefit of upper-income taxpayers' itemized deductions would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels.

Proposal

The Administration proposes to reinstate the limitation on itemized deductions for upper-income taxpayers. Itemized deductions (other than medical expenses, investment interest, theft and

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[8] The AGI floor for medical and dental expenses rises to 10 percent in 2013 for taxpayers under 65 years of age and in 2017 for all other taxpayers.

[9] In 2011, taxpayers could elect to deduct State and local general sales taxes instead of State and local income taxes. This Budget includes a proposal to extend that election for two years through 2013.

casualty losses, and gambling losses) would be reduced by 3 percent of the amount by which AGI exceeds statutory thresholds, but not by more than 80 percent of the otherwise allowable deductions. The thresholds would be $250,000 for married taxpayers filing joint returns, $225,000 for head-of household taxpayers, $200,000 for single taxpayers, and $125,000 for married taxpayers filing separately. The AGI thresholds are at 2009 levels, and would be indexed for inflation thereafter.

The change would be effective for taxable years beginning after December 31, 2012.

REINSTATE THE PERSONAL EXEMPTION PHASE-OUT FOR UPPER-INCOME TAXPAYERS

Current Law

Individual taxpayers generally are entitled to a personal exemption for the taxpayer and for each dependent. The amount of each personal exemption is $3,800 for 2012 and is indexed annually for inflation.

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Tax Act (EGTRRA) in 2001, all personal exemptions were reduced or completely phased out simultaneously for higher-income taxpayers. For a taxpayer with adjusted gross income (AGI) in excess of the threshold amount for the taxpayer's filing status, the amount of each personal exemption was reduced by 2 percent of the exemption amount for that year for each $2,500 ($1,250 if married filing separately) or fraction thereof by which AGI exceeded that threshold. EGTRRA temporarily eliminated this personal exemption phase-out, and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) extended this relief for two years through 2012. The baseline for this Budget assumes that relief from the phase-out of personal exemptions as provided by EGTRRA and TRUIRJCA is made permanent.

For 2012, if it were applicable, the AGI floor for the personal exemption phase-out would be $260,500 for married taxpayers filing a joint return ($173,650 for single taxpayers).

Reason for Change

Limiting the tax benefit of upper-income taxpayers' personal exemptions would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels.

Proposal

The Administration proposes to reinstate the phase-out of personal exemptions for upper-income taxpayers. The proposal would affect taxpayers with AGI above threshold levels that vary by filing status. The thresholds would be $250,000 for married taxpayers filing joint returns, $225,000 for head-of household taxpayers, $200,000 for single taxpayers, and $125,000 for married taxpayers filing separately. The AGI thresholds are at 2009 levels, and would be indexed for inflation thereafter. Under the proposal, the amount of each personal exemption would be reduced (but not below zero) by 2 percent of the exemption amount for that year for each $2,500 ($1,250 if married filing separately) or fraction thereof by which AGI exceeded the threshold.

The change would be effective for taxable years beginning after December 31, 2012

REINSTATE THE 36-PERCENT AND 39.6-PERCENT TAX RATES FOR UPPER-INCOME TAXPAYERS

Current Law

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001, the two highest individual income tax rates were 36 percent and 39.6 percent. EGTRRA temporarily reduced those tax rate brackets to 33 percent and 35 percent. Under EGTRRA, these tax rate reductions were scheduled to expire after 2010. The lower rates were extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Under current law they revert to 36 percent and 39.6 percent after December 31, 2012. However, the baseline for this Budget assumes that the 33 percent and 35 percent tax rates as provided by EGTRRA and TRUIRJCA are made permanent.

For 2012, the 33 percent rate applies to taxable income over $217,450 for married taxpayers filing a joint return (over $178,650 for single taxpayers). The 35 percent rate applies to taxable income over $388,350 for both married and single filers.

Reason for Change

Increasing the income tax liability of higher-income taxpayers would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels.

Proposal

The Administration proposes to replace part of the 33 percent and all of the 35 percent tax rate brackets with the prior law tax rate brackets of 36 percent and 39.6 percent. The 36-percent tax rate bracket would begin at taxable income level calculated as the appropriate AGI threshold minus the appropriate standard deduction and one personal exemption (two for married taxpayers filing jointly). The AGI thresholds would be $250,000 for married taxpayers filing joint returns, $225,000 for head-of household taxpayers, $200,000 for single taxpayers, and $125,000 for married taxpayers filing separately. The AGI thresholds are at 2009 levels, and would be indexed for inflation thereafter.

The change would be effective for taxable years beginning after December 31, 2012.

TAX QUALIFIED DIVIDENDS AS ORDINARY INCOME FOR UPPER-INCOME TAXPAYERS

Current Law

Under current law, the maximum income tax rate on qualified dividends received by individuals is 15 percent. In addition, any qualified dividends that would otherwise be taxed at a 10- or 15-percent ordinary income tax rate are taxed at a 0-percent rate. The same rates apply for purposes of the alternative minimum tax.

The 0- and 15-percent rates for qualified dividends are scheduled to expire for taxable years beginning after December 31, 2012. In 2013, all dividends would be taxed at ordinary individual income tax rates of up to 39.6 percent.

The Administration's revenue baseline assumes that the current 0- and 15-percent tax rates on qualified dividends are permanently extended for all taxpayers.

Reasons for Change

Restoring the ordinary income tax treatment of qualified dividends for upper-income taxpayers would reduce the deficit and make the tax system more progressive. Taxing qualified dividends at the same rates as other ordinary income would also help simplify the tax code.

Proposal

The proposal would allow the current reduced tax rates on qualified dividends to expire as scheduled for income that would be taxable in the 36 percent or 39.6 percent brackets.

This proposal would be effective for dividends received after December 31, 2012.

TAX NET LONG-TERM CAPITAL GAINS AT A 20-PERCENT RATE FOR UPPER-INCOME TAXPAYERS

Current Law

Under current law, the maximum rate of tax on net long-term capital gains of an individual is 15 percent. In addition, any capital gains that would otherwise be taxed at a 10- or 15-percent ordinary income tax rate are taxed at a 0-percent rate. Gains from recapture of depreciation on certain real estate (section 1250) are taxed at ordinary rates up to 25 percent. Gains from the sale of collectibles are taxed at ordinary rates up to 28 percent. Special provisions also apply to gains from the sale of certain small business stock. The same rates apply for purposes of the alternative minimum tax.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct up to $3,000 of capital losses from ordinary income each year. Any remaining unused capital losses may be carried forward indefinitely to a future year.

The 0- and 15-percent rates for capital gains are scheduled to expire for taxable years beginning after December 31, 2012. On January 1, 2013, the maximum income tax rate on capital gains would increase to 20 percent (18 percent for assets purchased after December 31, 2000 and held longer than five years).

The Administration's revenue baseline assumes that the current 0- and 15-percent tax rates on net long-term net capital gains are permanently extended for all taxpayers.

Reasons for Change

Restoring the 20-percent capital gains tax rate for upper-income taxpayers and repealing the reduced tax rates on gains from assets held over five years for would reduce the deficit and make the tax system more progressive.

Proposal

The proposal would allow the current reduced tax rates on long-term capital gains to expire as scheduled for capital gain income that, in the absence of any preferential treatment of long-term capital gains, would be taxable in the 36 percent or 39.6 percent brackets. It would also repeal the special reduced rate on gains from assets held over five years. Thus, the maximum long-term capital gains tax rate for upper-income taxpayers would be 20 percent.

The special rates applying to recapture of depreciation on certain real estate (Section 1250 recapture) and collectibles, and the special provisions applying to the sale of certain small business stock would be retained.

This proposal would be effective for long-term capital gains realized after December 31, 2012.

Reduce the Value of Certain Tax Expenditures

REDUCE THE VALUE OF CERTAIN TAX EXPENDITURES

Current Law

Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income (AGI), and claiming either itemized deductions or a standard deduction. The tax reduction from the last dollar excluded or deducted is $1.00 times the taxpayer's marginal income tax rate (e.g., if the marginal tax rate were 35 percent, tax value of the last dollar deducted would be 35 cents).

Certain types of income are excluded permanently or deferred temporarily from income subject to tax. These items include interest on State or local bonds, amounts paid by employers and employees for employer-sponsored health coverage, contributions to health savings accounts and Archer MSAs, amounts paid by employees and employers for defined contribution retirement plans, certain premiums for health insurance for self-employed individuals, certain income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, interest on education loans, and certain higher education expenses.

Individual taxpayers may elect to itemize their deductions instead of claiming a standard deduction. In general, itemized deductions include medical and dental expenses (in excess of 7.5 percent of AGI)[10], state and local property taxes and income taxes[11], interest paid, gifts to charities, casualty and theft losses (in excess of 10 percent of AGI), job expenses and certain miscellaneous expenses (some only in excess of 2 percent of AGI).

For upper-income taxpayers, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) were reduced prior to 2010 if AGI exceeded a statutory floor that was indexed annually for inflation. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) temporarily eliminated this provision and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) extended the elimination of the limitation on itemized deductions for two years, through 2012. The baseline for this Budget assumes that relief from this limitation on itemized deductions as provided by EGTRRA and TRUIRJCA is made permanent. However, another proposal in this Budget would reinstate this limitation on itemized deductions beginning in 2013 for upper-income taxpayers only.

[10] The AGI floor for medical and dental expenses rises to 10 percent in 2013 for taxpayers under 65 years of age and in 2017 for all other taxpayers.

[11] In 2011, taxpayers could elect to deduct state and local general sales taxes instead of state and local income taxes. This Budget includes a proposal to extend that election for two years through 2013.

Reasons for Change

Increasing the income tax liability of higher-income taxpayers would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels. In particular, limiting the value of tax expenditures including itemized deductions, certain exclusions in income subject to tax, and certain deductions in the computation of AGI, would reduce the benefit that high income taxpayers receive from those tax expenditures and help close the gap between the value of these tax expenditures for high-income Americans and the value for middle class Americans.

Proposal

The proposal would limit the tax value of specified deductions or exclusions from AGI and all itemized deductions. This limitation would reduce the value to 28 percent of the specified exclusions and deductions that would otherwise reduce taxable income in the 36-percent or 39.6-percent tax brackets. A similar limitation also would apply under the alternative minimum tax.

The income exclusions and deductions limited by this provision would include any tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, interest on education loans, and certain higher education expenses.

This proposal would apply to itemized deductions after they have been reduced by the statutory limitation on certain itemized deductions for higher income taxpayers.

The proposal would be effective for taxable years beginning after December 31, 2012.

MODIFY ESTATE AND GIFT TAX PROVISIONS

RESTORE THE ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PARAMETERS IN EFFECT IN 2009

Current Law

Until the end of 2012, the current estate, generation-skipping transfer, and gift tax rate is 35 percent, and each individual has a lifetime exclusion for all three types of taxes of $5 million (indexed after 2011 for inflation from 2010). The surviving spouse of a person who dies after December 31, 2010, may be eligible to increase the surviving spouse's exclusion amount by the portion of the predeceased spouse's exclusion that remained unused at the predeceased spouse's death (in other words, the exclusion is "portable"). However, after 2012, the tax rate and tax brackets, the amount of the exclusion, and the law governing these three types of taxes will revert to the law in effect in 2001, as if the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) had never been enacted. Portability of the exemption between spouses for both gift and estate tax purposes, enacted as part of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRUIRJCA), also will no longer apply.

Prior to the enactment of EGTRRA in 2001, the maximum tax rate was 55 percent, plus a 5-percent surcharge on the amount of the taxable estate between approximately $10 million and $17.2 million (designed to recapture the benefit of the lower rate brackets). The exclusion for estate and gift tax purposes was $675,000 and was scheduled to increase to $1 million by 2006. Under EGTRRA, beginning in 2002, the top tax rate for all three types of taxes was reduced incrementally until it was 45 percent in 2007. In 2004, the exemption for estate taxes (but not for gift taxes) began to increase incrementally until it was $3.5 million in 2009, and the generation-skipping transfer (GST) tax exemption and rate became unified with the estate tax exemption and rate. During this post-EGTRRA period through 2009, the gift tax exemption remained $1 million. Under EGTRRA, for 2010, the estate tax was replaced with carryover basis treatment of bequests, the GST tax was not applicable, and the gift tax remained in effect with a $1 million exclusion and a 35-percent tax rate. The EGTRRA provisions were scheduled to expire at the end of 2010, meaning that the estate tax and GST tax would be inapplicable for only one year.

In 2010, TRUIRJCA retroactively changed applicable law for 2010 by providing a top estate tax rate of 35 percent for taxpayers electing estate tax rather than carryover-basis treatment. It also retroactively reinstated the GST tax and unified the exemption for estate, GST, and gift taxes beginning in 2011 with a $5 million total lifetime exclusion for all three taxes (indexed after 2011 for inflation from 2010). The Administration's FY 2013 baseline assumes that the estate tax provisions in effect in 2012 are permanent.

Reasons for Change

TRUIRJCA provided a substantial tax cut to the most affluent taxpayers that we cannot afford to continue. We need a permanent estate tax law that provides certainty to taxpayers, is fair, and raises an appropriate amount of revenue.

Proposal

The proposal would make permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate would be 45 percent and the exclusion amount would be $3.5 million for estate and GST taxes, and $1 million for gift taxes. As reflected in the Administration's adjusted baseline projection, the portability of unused estate and gift tax exclusion between spouses would be made permanent.

The proposal would be effective for the estates of decedents dying, and for transfers made, after December 31, 2012.

REQUIRE CONSISTENCY IN VALUE FOR TRANSFER AND INCOME TAX PURPOSES

Current Law

Section 1014 provides that the basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. Similarly, property included in the decedent's gross estate for estate tax purposes generally must be valued at its fair market value on the date of death. Although the same valuation standard applies to both provisions, current law does not explicitly require that the recipient's basis in that property be the same as the value reported for estate tax purposes.

Section 1015 provides that the donee's basis in property received by gift during the life of the donor generally is the donor's adjusted basis in the property, increased by gift tax paid on the transfer. If, however, the donor's basis exceeds the fair market value of the property on the date of the gift, the donee's basis is limited to that fair market value for purposes of determining any subsequent loss.

Section 1022, applicable to the estates of decedents dying during 2010 if a timely election to that effect is made, provides that the basis of property acquired from such a decedent is the lesser of the fair market value of the property on the decedent's date of death or the decedent's adjusted basis in that property as increased by the additional basis (if any) allocated to that property by the executor under section 1022.

Section 6034A imposes a consistency requirement – specifically, that the recipient of a distribution of income from a trust or estate must report on the recipient's own income tax return the exact information included on the Schedule K-1 of the trust's or estate's income tax return – but this provision applies only for income tax purposes, and the Schedule K-1 does not include basis information.

Reasons for Change

Taxpayers should be required to take consistent positions in dealing with the Internal Revenue Service. The basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. Consistency requires that the same value be used by the recipient (unless that value is in excess of the accurate value). In the case of property transferred on death or by gift during life, often the executor of the estate or the donor, respectively, will be in the best position to ensure that the recipient receives the information that will be necessary to accurately determine the recipient's basis in the transferred property.

Proposal

This proposal would impose both a consistency and a reporting requirement. The basis of property received by reason of death under section 1014 must equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor must equal the donor's basis determined under section 1015. The basis of property acquired from a decedent to whose estate section 1022 is applicable is the basis of that property, including any additional basis allocated by the executor, as reported on the Form 8939 that the executor filed. This proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments).

A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary valuation and basis information to both the recipient and the Internal Revenue Service.

A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

The proposal would be effective for transfers on or after the date of enactment.

MODIFY RULES ON VALUATION DISCOUNTS

Current Law

The fair market value of property transferred, whether on the death or during the life of the transferor, generally is subject to estate or gift tax at the time of the transfer. Sections 2701 through 2704 of the Internal Revenue Code were enacted to prevent the reduction of taxes through the use of "estate freezes" and other techniques designed to reduce the value of the transferor's taxable estate and discount the value of the taxable transfer to the beneficiaries of the transferor without reducing the economic benefit to the beneficiaries. Generally, section 2704(b) provides that certain "applicable restrictions" (that would normally justify discounts in the value of the interests transferred) are to be ignored in valuing interests in family-controlled entities if those interests are transferred (either by gift or on death) to or for the benefit of other family members. The application of these special rules results in an increase in the transfer tax value of those interests above the price that a hypothetical willing buyer would pay a willing seller, because section 2704(b) generally directs an appraiser to ignore the rights and restrictions that otherwise would support significant discounts for lack of marketability and control.

Reasons for Change

Judicial decisions and the enactment of new statutes in most states, in effect, have made section 2704(b) inapplicable in many situations by recharacterizing restrictions such that they no longer fall within the definition of an "applicable restriction." In addition, the Internal Revenue Service has identified other arrangements designed to circumvent the application of section 2704.

Proposal

This proposal would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or to hold an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

REQUIRE A MINIMUM TERM FOR GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

Current Law

Section 2702 provides that, if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is valued at zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a "qualified interest." A fixed annuity, such as the annuity interest retained by the grantor of a GRAT, is one form of qualified interest, so the gift of the remainder interest in the GRAT is determined by deducting the present value of the retained annuity during the GRAT term from the fair market value of the property contributed to the trust.

Generally, a GRAT is an irrevocable trust funded with assets expected to appreciate in value, in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries, who generally are descendants of the grantor. If the grantor dies during the GRAT term, however, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor's gross estate for estate tax purposes. To this extent, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax-free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized.

Reasons for Change

GRATs have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, providing that the grantor survives the GRAT term and the trust assets do not depreciate in value. The greater the appreciation, the greater the transfer tax benefit achieved. Taxpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.

Proposal

This proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. Although a minimum term would not prevent "zeroing-out" the gift tax value of the remainder interest, it would increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit.

This proposal would apply to trusts created after the date of enactment.

LIMIT DURATION OF GENERATION-SKIPPING TRANSFER (GST) TAX EXEMPTION

Current Law

Generation-skipping transfer tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor. The GST tax was enacted to prevent the avoidance of estate and gift taxes through the use of a trust that gives successive life interests to multiple generations of beneficiaries. In such a trust, no estate tax would be incurred as beneficiaries died because their respective life interests would die with them and thus would cause no inclusion of the trust assets in the deceased beneficiary's gross estate. The GST tax is a flat tax on the value of the transfer at the highest estate tax bracket applicable in that year. Each person has a lifetime GST tax exemption ($5,120,000 in 2012) that can be allocated to transfers made, whether directly or in trust, by that person to a grandchild or other "skip person." The allocation of GST exemption to a transfer or to a trust excludes from the GST tax not only the amount of the transfer or trust assets equal to the amount of GST exemption allocated, but also all appreciation and income on that amount during the existence of the trust.

At the time of the enactment of the GST provisions, the law of most (all but about three) states included the common law Rule Against Perpetuities (RAP) or some statutory version of it. The RAP generally requires that every trust terminate no later than 21 years after the death of a person who was alive (a life in being) at the time of the creation of the trust.

Reasons for Change

Many states now either have repealed or limited the application of their RAP statutes, with the effect that trusts created subject to the law of those jurisdictions may continue in perpetuity. (A trust may be sitused anywhere; a grantor is not limited to the jurisdiction of the grantor's domicile for this purpose.) As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with $1 million (the exemption at the time of enactment) and a maximum duration limited by the RAP, to trusts funded with $5,120,000 and continuing (and growing) in perpetuity.

Proposal

This proposal would provide that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from a different grantor are deemed to be held in a separate trust under section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts will be deemed to have the same date of creation as the initial trust, with one exception, as follows. If, prior to the 90th anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as described in section 2642(c)(2), the inclusion ratio of the distributee trust will not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on the beneficiary's death will be included in the beneficiary's gross estate for Federal estate tax purposes. The other rules of section 2653 also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision.

This proposal would apply to trusts created after enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).

COORDINATE CERTAIN INCOME AND TRANSFER TAX RULES APPLICABLE TO GRANTOR TRUSTS

Current Law

A grantor trust is a trust, whether revocable or irrevocable, of which an individual is treated as the owner for income tax purposes. For income tax purposes, a grantor trust is taxed as if the grantor or another person owns the trust assets directly, and the deemed owner and the trust are treated as the same person. Thus, transactions between the trust and the deemed owner are ignored. For transfer tax purposes, however, the trust and the deemed owner are separate persons, and under certain circumstances the trust is not included in the deemed owner's gross estate for estate tax purposes at the death of the deemed owner.

Reasons for Change

The lack of coordination between the income and transfer tax rules applicable to a grantor trust creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences.

Proposal

To the extent that the income tax rules treat a grantor of a trust as an owner of the trust, the proposal would (1) include the assets of that trust in the gross estate of that grantor for estate tax purposes, (2) subject to gift tax any distribution from the trust to one or more beneficiaries during the grantor's life, and (3) subject to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the trust for income tax purposes. In addition, the proposal would apply to any non-grantor who is deemed to be an owner of the trust and who engages in a sale, exchange, or comparable transaction with the trust that would have been subject to capital gains tax if the person had not been a deemed owner of the trust. In such a case, the proposal would subject to transfer tax the portion of the trust attributable to the property received by the trust in that transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction. The proposal would reduce the amount subject to transfer tax by the value of any taxable gift made to the trust by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts (GRITs); grantor retained annuity trusts (GRATs); personal residence trusts (PRTs); and qualified personal residence trusts (QPRTs).

The proposal would be effective with regard to trusts created on or after the date of enactment and with regard to any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment. Regulatory authority would be granted, including the ability to create transition relief for certain types of automatic, periodic contributions to existing grantor trusts.

EXTEND THE LIEN ON ESTATE TAX DEFERRALS PROVIDED UNDER SECTION 6166 OF THE INTERNAL REVENUE CODE

Current Law

Section 6166 of the Internal Revenue Code allows the deferral of estate tax on certain closely held business interests for up to fourteen years from the (unextended) due date of the estate tax payment (up to fifteen years and three months from date of death). This provision was enacted to reduce the possibility that the payment of the estate tax liability could force the sale or failure of the business. Section 6324(a)(1) imposes a lien on estate assets generally for the ten-year period immediately following the decedent's death to secure the full payment of the estate tax. Thus, the estate tax lien under section 6324(a)(1) expires approximately five years before the due date of the final payment of the deferred estate tax under section 6166.

Reasons for Change

In many cases, the IRS has had difficulty collecting the deferred estate tax, often because of business failures during that tax deferral period. The IRS sometimes requires either an additional lien or some form of security, but these security interests generally are prohibitively expensive and damaging to the day-to-day conduct and financing of the business. In addition, unless these other security measures are put in place toward the beginning of the deferral period, there is a risk that other creditors could have a higher priority interest than the Government.

Proposal

This proposal would extend the estate tax lien under section 6324(a)(1) throughout the section 6166 deferral period.

The proposal would be effective for the estates of all decedents dying on or after the effective date, as well as for all estates of decedents dying before the date of enactment as to which the section 6324(a)(1) lien has not expired on the effective date.

REFORM U.S. INTERNATIONAL TAX SYSTEM

DEFER DEDUCTION OF INTEREST EXPENSE RELATED TO DEFERRED INCOME OF FOREIGN SUBSIDIARIES

Current Law

Taxpayers generally may deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business. The Internal Revenue Code and the regulations thereunder contain detailed rules regarding allocation and apportionment of expenses for computing taxable income from sources within and without the United States. Under current rules, a U.S. person that incurs interest expense properly allocable and apportioned to foreign-source income may deduct those expenses even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. For example, a U.S. person that incurs debt to acquire stock of a foreign corporation is generally permitted to deduct currently the interest expense from the acquisition indebtedness even if no income is derived currently from such stock. Current law includes provisions that may require a U.S. person to recapture as U.S.-source income the amount by which foreign-source expenses exceed foreign-source income for a taxable year. However, if in a taxable year the U.S. person earns sufficient foreign-source income of the same statutory grouping in which the stock of the foreign corporation is classified, expenses, such as interest expense, properly allocated and apportioned to the stock of the foreign corporation may not be subject to recapture in a subsequent taxable year.

Reasons for Change

The ability to deduct expenses from overseas investments while deferring U.S. tax on the income from the investment may cause U.S. businesses to shift their investments and jobs overseas, harming our domestic economy.

Proposal

The proposal would defer the deduction of interest expense that is properly allocated and apportioned to stock of a foreign corporation that exceeds an amount proportionate to the taxpayer's pro rata share of income from such subsidiaries that is currently subject to U.S. tax. Under the proposal, foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax; thus, the proposal would not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign source income (for example, royalty income) would be similarly treated.

For purposes of the proposal, the amount of a taxpayer's interest expense that is properly allocated and apportioned to stock of a foreign corporation would generally be determined under the principles of current Treasury regulations. The Treasury Department, however, will continue to revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income.

Interest expense that is deferred under the proposal would be deductible in a subsequent tax year to the extent that the amount of interest expense allocated and apportioned to stock of foreign subsidiaries in such subsequent year is less than the annual limitation for that year. Treasury regulations may modify the manner in which a taxpayer can deduct previously deferred interest expenses in certain cases.

The proposal would be effective for taxable years beginning after December 31, 2012.

DETERMINE THE FOREIGN TAX CREDIT ON A POOLING BASIS

Current Law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. Under section 902, a domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the deemed paid foreign tax credit). The foreign tax credit is limited to an amount equal to the pre-credit U.S. tax on the taxpayer's foreign-source income. This foreign tax credit limitation is applied separately to foreign-source income in each of the separate categories described in section 904(d)(1), i.e., the passive category and general category.

Reasons for Change

The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign-source income. The reduction to two foreign tax credit limitation categories, for passive category income and general category income under the American Jobs Creation Act of 2004, enhanced U.S. taxpayers' ability to reduce the residual U.S. tax on foreign-source income through "cross-crediting."

Proposal

The proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis taking into account the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in section 902(b)). The deemed paid foreign tax credit for a taxable year would be limited to an amount proportionate to the taxpayer's pro rata share of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year that are currently subject to U.S. tax. Foreign taxes deferred under this proposal in prior years would be creditable in a subsequent taxable year to the extent that the amount of deemed paid foreign taxes in the current year are less than the annual limitation for that year. The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

The proposal would be effective for taxable years beginning after December 31, 2012.

TAX CURRENTLY EXCESS RETURNS ASSOCIATED WITH TRANSFERS OF INTANGIBLES OFFSHORE

Current Law

Section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." The regulations under section 482 provide that the standard to be applied is that of unrelated persons dealing at arm's length. In the case of transfers of intangible assets, section 482 further provides that the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets.

In general, the subpart F rules (sections 951-964) require U.S. shareholders with a 10- percent or greater interest in a controlled foreign corporation (CFC) to include currently in income for U.S. tax purposes their pro rata share of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is actually distributed to the shareholders. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the corporation's voting stock.

Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other proscribed activities. Foreign base company income consists of foreign personal holding company income (which includes passive income such as dividends, interest, rents, royalties, and annuities) and other categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

A foreign tax credit is generally available for foreign income taxes paid by a CFC to the extent that the CFC's income is taxed to a U.S. shareholder under subpart F, subject to the limitations set forth in section 904.

Reasons for Change

The potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, puts significant pressure on the enforcement and effective application of transfer pricing rules. There is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base. Expanding subpart F to include excess income from intangibles transferred to low-taxed affiliates will reduce the incentive for taxpayers to engage in these transactions.

Proposal

The proposal would provide that if a U.S. person transfers (directly or indirectly) an intangible from the United States to a related CFC (a "covered intangible"), then certain excess income from transactions connected with or benefitting from the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate. In the case of an effective tax rate of 10 percent or less, the proposal would treat all excess income as subpart F income, and would then phase out ratably for effective tax rates of 10 to 15 percent. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with or benefitting 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, the transfer of an intangible includes by sale, lease, license, or through any shared risk or development agreement (including any cost sharing arrangement)). This subpart F income will be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under section 904.

The proposal would be effective for transactions in taxable years beginning after December 31, 2012.

LIMIT SHIFTING OF INCOME THROUGH INTANGIBLE PROPERTY TRANSFERS

Current Law

Section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." Section 482 also provides that in the case of transfers of intangible assets, the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets. Further, under section 367(d), if a U.S. person transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign corporation in certain nonrecognition transactions, the U.S. person is treated as selling the intangible property for a series of payments contingent on the productivity, use, or disposition of the property that are commensurate with the transferee's income from the property. The payments generally continue annually over the useful life of the property.

Reasons for Change

Controversy often arises concerning the value of intangible property transferred between related persons and the scope of the intangible property subject to sections 482 and 367(d). This lack of clarity may result in the inappropriate avoidance of U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign persons.

Proposal

The 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 also would clarify that where multiple intangible properties are transferred, the Commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the Commissioner 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.

The proposal would be effective for taxable years beginning after December 31, 2012.

DISALLOW THE DEDUCTION FOR NON-TAXED REINSURANCE PREMIUMS PAID TO AFFILIATES

Current Law

Insurance companies are generally allowed a deduction for premiums paid for reinsurance. If the reinsurance transaction results in a transfer of reserves and reserve assets to the reinsurer, potential tax liability for earnings on those assets is generally shifted to the reinsurer as well. While insurance income of a controlled foreign corporation is generally subject to current U.S. taxation, insurance income of a foreign-owned foreign company that is not engaged in a trade or business in the United States is not subject to U.S. income tax. Reinsurance policies issued by foreign reinsurers with respect to U.S. risks are generally subject to an excise tax equal to 1 percent of the premiums paid, unless waived by treaty.

Reasons for Change

Reinsurance transactions with affiliates that are not subject to U.S. federal income tax on insurance income can result in substantial U.S. tax advantages over similar transactions with entities that are subject to tax in the United States. The excise tax on reinsurance policies issued by foreign reinsurers is not always sufficient to offset this tax advantage. These tax advantages create an inappropriate incentive for foreign-owned domestic insurance companies to reinsure U.S. risks with foreign affiliates.

Proposal

The proposal would (1) deny an insurance company a deduction for premiums and other amounts paid to affiliated foreign companies with respect to reinsurance of property and casualty risks 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) would exclude from the insurance company's income (in the same proportion in which the premium deduction was denied) any return premiums, ceding commissions, reinsurance recovered, or other amounts received 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 would otherwise be denied a deduction under this proposal would be 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 would be treated as foreign source income and would be placed into a separate category within section 904.

The provision is effective for policies issued in taxable years beginning after December 31, 2012.

LIMIT EARNINGS STRIPPING BY EXPATRIATED ENTITIES

Current Law

Section 163(j) limits the deductibility of certain interest paid by a corporation to related persons. The limitation applies to a corporation that fails a debt-to-equity safe harbor (greater than 1.5 to 1), and that has net interest expense in excess of 50 percent of adjusted taxable income (generally computed by adding back net interest expense, depreciation, amortization and depletion, any net operating loss deduction, and any deduction for domestic production activities under section 199). Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year. In addition, the corporation's excess limitation for a tax year (i.e., the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent tax years.

Section 7874 provides special rules for expatriated entities and the acquiring foreign corporations. The rules apply to certain defined transactions in which a U.S. parent company (the expatriated entity) is essentially replaced with a foreign parent (the surrogate foreign corporation). The tax treatment of an expatriated entity and a surrogate foreign corporation varies depending on the extent of continuity of shareholder ownership following the transaction. The surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code if shareholder ownership continuity is at least 80 percent (by vote or value). If shareholder ownership continuity is at least 60 percent, but less than 80 percent, the surrogate foreign corporation is treated as a foreign corporation but certain tax consequences apply, including that any applicable corporate-level income or gain required to be recognized by the expatriated entity generally cannot be offset by tax attributes. Section 7874 generally applies to transactions occurring on or after March 4, 2003.

Reasons for Change

Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. In its 2007 study of earnings stripping, the Treasury Department found strong evidence of the use of such techniques by expatriated entities. Consequently, amending the rules of section 163(j) for expatriated entities is necessary to prevent these inappropriate income-reduction opportunities.

Proposal

The proposal would revise section 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons. The current law debt-to-equity safe harbor would be eliminated. The 50 percent adjusted taxable income threshold for the limitation would be reduced to 25 percent. The carryforward for disallowed interest would be limited to ten years, and the carryforward of excess limitation would be eliminated.

An expatriated entity would be defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989. This special rule would not apply, however, if the surrogate foreign corporation is treated as a domestic corporation under section 7874.

The proposal would be effective for taxable years beginning after December 31, 2012.

MODIFY TAX RULES FOR DUAL CAPACITY TAXPAYERS

Current Law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States.

To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under United States tax principles, regardless of the label attached to the levy under law. Under current Treasury regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive a specific economic benefit from the levying country (dual capacity taxpayers) may not credit the portion of the foreign levy paid for the specific economic benefit. The current Treasury regulations provide that, if a foreign country has a generally-imposed income tax, the dual capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed income tax would yield (provided that the levy otherwise constitutes an income tax or an in lieu of tax). The balance of the levy is treated as compensation for the specific economic benefit. If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable federal tax rate applied to net income is treated as a creditable tax. A foreign tax is treated as generally imposed even if it applies only to persons who are not residents or nationals of that country.

There is no separate section 904 foreign tax credit limitation category for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on foreign oil and gas income is limited in any year to the applicable U.S. tax on that income.

Reasons for Change

The purpose of the foreign tax credit is to mitigate double taxation of income by the United States and a foreign country. When a payment is made to a foreign country in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between a payment of creditable taxes and a payment in exchange for a specific economic benefit but fails to achieve the appropriate split between the two when a single payment is made in a case where, for example, a foreign country imposes a levy only on oil and gas income, or imposes a higher levy on oil and gas income as compared to other income.

Proposal

The proposal would allow a dual capacity taxpayer 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 would replace 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 would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would yield to United States treaty obligations to the extent that they explicitly allow a credit for taxes paid or accrued on certain oil or gas income.

The proposal would be effective for taxable years beginning after December 31, 2012.

TAX GAIN FROM THE SALE OF A PARTNERSHIP INTEREST ON LOOK-THROUGH BASIS

Current Law

In general, the sale or exchange of a partnership interest is treated as the sale or exchange of a capital asset. Capital gains of a nonresident alien individual or foreign corporation generally are subject to federal income tax only if the gains are or are treated as income that is effectively connected with the conduct of a trade or business in the United States (ECI). Section 875(1) provides that a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged. Revenue Ruling 91-32 holds that gain or loss of a nonresident alien individual or foreign corporation from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent of the partner's distributive share of unrealized gain or loss of the partnership that is attributable to property used or held for use in the partnership's trade or business within the United States (ECI property). A partnership may elect under section 754 to adjust the basis of its assets upon the transfer of an interest in the partnership to reflect the transferee partner's basis in the partnership interest.

Reasons for Change

Nonresident alien individuals and foreign corporations may take a position contrary to the holding of Revenue Ruling 91-32, arguing that gain from the sale of a partnership interest is not subject to federal income taxation because no Code provision explicitly provides that gain from the sale or exchange of a partnership interest by a nonresident alien individual or foreign corporation is treated as ECI. If the partnership has in effect an election under section 754, the partnership's basis in its assets is also increased, thereby preventing that gain from being taxed in the future.

Proposal

The proposal would provide that gain or loss from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

In addition, the transferee of a partnership interest would be required to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certified that the transferor was not a nonresident alien individual or foreign corporation. If a transferor provided a certificate from the IRS that established that the transferor's federal income tax liability with respect to the transfer was less than 10 percent of the amount realized, the transferee would withhold such lesser amount. If the transferee failed to withhold the correct amount, the partnership would be liable for the amount of underwithholding, and would satisfy the withholding obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

The proposal would be effective for sales or exchanges after December 31, 2012.

PREVENT USE OF LEVERAGED DISTRIBUTIONS FROM RELATED FOREIGN CORPORATIONS TO AVOID DIVIDEND TREATMENT

Current Law

Section 301 provides rules for characterizing a distribution of property by a corporation to a shareholder. The amount of the distribution is first treated as a dividend to the extent of the distributing corporation's applicable earnings and profits. To the extent the amount of the distribution exceeds the distributing corporation's applicable earnings and profits, the excess amount is treated as a reduction in the shareholder's adjusted tax basis in the stock of the distributing corporation, and then any remaining excess is treated by the shareholder as gain from the sale or exchange of property. For these purposes, a corporation generally calculates its earnings and profits on a stand-alone basis, with special rules for consolidated groups.

Reasons for Change

Under current law, the determination of whether a corporate distribution is a dividend effectively permits the earnings and profits of one corporation to be repatriated without being characterized as a dividend by having such corporation fund a distribution from a second, related corporation that does not have earnings and profits, but in which the distributee shareholder has sufficient tax basis to characterize the distribution (in whole or substantial part) as a return of stock basis under the ordering rules of section 301.

Proposal

The proposal would provide that to the extent a foreign corporation (the "funding corporation") funds a second, related foreign corporation (the "foreign distributing corporation") with a principal purpose of avoiding dividend treatment on distributions to a U.S. shareholder, the U.S. shareholder's basis in the stock of the distributing corporation will not be taken into account for the purpose of determining the treatment of the distribution under section 301. For this purpose, the funding corporation and the foreign distributing corporation are related if they are members of a control group within the meaning of section 1563(a), but replacing the reference to "at least 80 percent" with "more than 50 percent." Funding transactions to which the proposal would apply include capital contributions, loans, or distributions to the foreign distributing corporation, whether the funding transaction occurs before or after the distribution.

The proposal would apply to distributions after December 31, 2012.

EXTEND SECTION 338(H)(16) TO CERTAIN ASSET ACQUISITIONS

Current Law

A corporation that makes a qualified stock purchase of a target corporation is permitted to elect under section 338 (a “section 338 election”) to treat the stock acquisition as an asset acquisition, thereby stepping up the tax basis of the target corporation’s assets. For this purpose, a qualified stock purchase is any transaction or series of transaction in which the purchasing corporation acquires 80 percent of the stock of the target corporation. Section 338(h)(16) provides that (subject to certain exceptions) the deemed asset sale resulting from a section 338 election is not treated as occurring for purposes of determining the source or character of any item for purpose of applying the foreign tax credit rules to the seller. Instead, for these purposes, the gain is generally treated by the seller as gain from the sale of the stock. Thus, section 338(h)(16) prevents a seller from increasing allowable foreign tax credits as a result of a section 338 election.

Section 901(m) denies a credit for certain foreign taxes paid or accrued after a covered asset acquisition (a “CAA”).   A CAA includes a section 338 election made with respect to a qualified stock purchase as well as other transactions that are treated as asset acquisitions for U.S. tax purposes but the acquisition of an interest in an entity for foreign tax purposes.

Reasons for Change

Section 338(h)(16) applies to a qualified stock purchase for which a section 338 election is made, but it does not apply to the other types of CAAs subject to the credit disallowance rules under section 901(m). These other types of CAAs present the same foreign tax credit concerns as those addressed by section 338(h)(16) in the case of a qualified stock purchase for which a section 338 election is made.

Proposal

The proposal would extend the application of section 338(h)(16) to any CAA, within the meaning of section 901(m). The Secretary would be granted authority to issue Treasury regulations necessary to carry out the purposes of the proposal.

The proposal would apply to CAAs occurring after December 31, 2012.

REMOVE FOREIGN TAXES FROM A SECTION 902 CORPORATION'S FOREIGN TAX POOL WHEN EARNINGS ARE ELIMINATED

Current Law

Section 902 provides that a domestic corporation owning at least 10 percent of the voting stock of a foreign corporation is allowed a credit for foreign taxes paid by a foreign corporation if the domestic corporation receives a dividend distribution from the foreign corporation or, in certain circumstances, if it has a subpart F income inclusion that is treated as a deemed dividend for purposes of section 902.

Certain transactions result in a reduction, allocation, or elimination of a corporation's earnings and profits other than by reason of a dividend or deemed dividend, or by reason of section 381 (generally providing that earnings and profits and other tax attributes of a target corporation carry over to an acquiring corporation in a tax-free restructuring transaction). For example, if a corporation redeems a portion of its stock and the redemption is treated as a sale or exchange, there is a reduction in the earnings and profits (if any) of the redeeming corporation (see section 312(n)(7)). As another example, certain section 355 distributions can result in the reduction of the distributing corporation's earnings and profits (see section 312(h) and the regulations thereunder).

Reasons for Change

The elimination of earnings and profits without a corresponding reduction in the associated foreign taxes paid results in a taxpayer claiming an indirect credit under section 902 for foreign taxes paid with respect to earnings that will no longer fund a dividend distribution for U.S. income tax purposes.

Proposal

The proposal would reduce the amount of foreign taxes paid by a foreign corporation in the event a transaction results in the elimination of a foreign corporation's earnings and profits other than a reduction of earnings and profits by reason of a dividend or deemed dividend, or by reason of a section 381 transaction. The amount of foreign income taxes that would be reduced in such a transaction would equal the amount of foreign taxes associated with the eliminated earnings and profits.

The proposal would be effective for transactions occurring after December 31, 2012.

REFORM TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY INSTITUTIONS AND PRODUCTS

IMPOSE A FINANCIAL CRISIS RESPONSIBILITY FEE

Current Law

There is no sector-specific Federal tax applied to financial firms (although these firms are subject to the general corporate income tax and potentially a wide range of excise taxes). Financial sector firms are subject to a range of fees, depending on the lines of business in which they participate. For example, banks are assessed fees by the Federal Deposit Insurance Corporation to cover the costs of insuring deposits made at these institutions.

Reasons for Change

Excessive risk undertaken by major financial firms was a significant cause of the recent financial crisis. Extraordinary steps were taken by the Federal government to inject funds into the financial system, guarantee certain types of securities, and purchase securities from weakened firms. The law that enabled some of these actions and that created the Troubled Asset Relief Program (TARP) requires the President to propose an assessment on the financial sector to pay back the costs of these extraordinary actions. Accordingly, the Financial Crisis Responsibility Fee is intended to recoup the costs of the TARP program as well as discourage excessive risk-taking, as the combination of high levels of risky assets and less stable sources of funding were key contributors to the financial crisis. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders and similar to fees that have been adopted or proposed by other countries.

Proposal

The Financial Crisis Responsibility Fee would be assessed on certain liabilities of the largest firms in the financial sector. Specific components of the proposal are described below.

Firms Subject to the Fee: The fee would apply to U.S.-based bank holding companies, thrift holding companies, certain broker-dealers, companies that control certain broker-dealers, and insured depository institutions. U.S. companies owning or controlling these types of entities as of January 14, 2010 also would be subject to the fee. Firms with worldwide consolidated assets of less than $50 billion would not be subject to the fee for the period when their assets are below this threshold. U.S. subsidiaries of foreign firms that fall into these categories and that have assets in excess of $50 billion also would be covered.

Base of Fee: The fee would be based on the covered liabilities of a financial firm. Covered liabilities are generally the consolidated risk-weighted assets of a financial firm, less its capital, insured deposits, and certain loans to small business. These would be computed using information filed with the appropriate Federal or State regulators. For insurance companies, certain policy reserves and other policyholder obligations also would be deducted in computing covered liabilities. In addition, adjustments would be provided to prevent avoidance.

Fee Rates: The rate of the fee applied to covered liabilities would be 17 basis points. A 50-percent discount would apply to more stable sources of funding, including long-term liabilities.

Deductibility: The fee would be deductible in computing corporate income tax.

Filing and Payment Requirements: A financial entity subject to the fee would report it on its annual Federal income tax return. Estimated payments of the fee would be made on the same schedule as estimated income tax payments.

The fee would be effective as of January 1, 2014.

REQUIRE ACCRUAL OF INCOME ON FORWARD SALE OF CORPORATE STOCK

Current Law

A corporation generally does not recognize gain or loss on the issuance or repurchase of its own stock. Thus, a corporation does not recognize gain or loss on the forward sale of its own stock. A corporation sells its stock forward by agreeing to issue its stock in the future in exchange for specified consideration to be paid in the future.

Although a corporation does not recognize gain or loss on the issuance of its own stock, a corporation does recognize interest income upon the current sale of any stock (including its own) for deferred payment.

Reasons for Change

There is little substantive difference between a corporate issuer's current sale of its stock for deferred payment and an issuer's forward sale of the same stock. The only difference between the two transactions is the timing of the stock issuance. In a current sale, the stock is issued at the inception of the transaction, but in a forward sale, the stock is issued at the time the deferred payment is received. In both cases, a portion of the deferred payment economically compensates the corporation for the time value of deferring receipt of the payment. It is inappropriate to treat these two transactions differently.

Proposal

The proposal would require 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.

The proposal would be effective for forward contracts entered into after December 31, 2012.

REQUIRE ORDINARY TREATMENT OF INCOME FROM DAY-TO-DAY DEALER ACTIVITIES FOR CERTAIN DEALERS OF EQUITY OPTIONS AND COMMODITIES

Current Law

Under current law, certain dealers treat the income from some of their day-to-day dealer activities as capital gain. This special rule applies to certain transactions in section 1256 contracts by commodities dealers (within the meaning of section 1402(i)(2)(B)), commodities derivatives dealers (within the meaning of section 1221(b)(1)(A)), dealers in securities (within the meaning of section 475(c)(1)), and options dealers (within the meaning of section 1256(g)(8)). Under section 1256, these dealers treat 60 percent of their income (or loss) from their dealer activities in section 1256 contracts as long-term capital gain (or loss) and 40 percent of their income (or loss) from these dealer activities as short-term capital gain (or loss). Dealers in other types of property generally treat the income from their day-to-day dealer activities as ordinary income.

Reasons for Change

There is no reason to treat dealers in commodities, commodities derivatives, securities, and options differently from dealers in other types of property. Dealers earn their income from their day-to-day dealer activities, and this income should be taxed at ordinary rates.

Proposal

The proposal would require dealers in commodities, commodities derivatives, securities, and options to treat the income from their day-to-day dealer activities in section 1256 contracts as ordinary in character, not capital. The proposal would apply to partnerships as well as individuals.

The proposal would be effective for taxable years beginning after the date of enactment.

MODIFY THE DEFINITION OF "CONTROL" FOR PURPOSES OF SECTION 249

Current Law

In general, if a corporation repurchases a debt instrument that is convertible into its stock, or into stock of a corporation in control of, or controlled by, the corporation, section 249 may disallow or limit the issuer's deduction for a premium paid to repurchase the debt instrument. For this purpose, "control" is determined by reference to section 368(c), which encompasses only direct relationships (e.g., a parent corporation and its wholly-owned, first-tier subsidiary).

Reasons for Change

The definition of "control" in section 249 is unnecessarily restrictive and has allowed the limitation in section 249 to be too easily avoided. Indirect control relationships (e.g., a parent corporation and a second-tier subsidiary) present the same economic identity of interests as direct control relationships and should be treated in a similar manner.

Proposal

The proposal would amend the definition of "control" in section 249(b)(2) to incorporate indirect control relationships of the nature described in section 1563(a)(1).

The proposal would be effective on the date of enactment.

MODIFY RULES THAT APPLY TO SALES OF LIFE INSURANCE CONTRACTS

Current Law

The seller of a life insurance contract generally must report as taxable income the difference between the amount received from the buyer and the adjusted basis in the contract, unless the buyer is a viatical settlement provider and the insured person is terminally or chronically ill.

Under a transfer-for-value rule, the buyer of a previously issued life insurance contract who subsequently receives a death benefit generally is subject to tax on the difference between the death benefit received and the sum of the amount paid for the contract and premiums subsequently paid by the buyer. This rule does not apply if the buyer's basis is determined in whole or in part by reference to the seller's basis, nor does the rule apply if the buyer is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

Persons engaged in a trade or business that make payments of premiums, compensation, remunerations, other fixed or determinable gains, profits, and income, or certain other types of payments in the course of that trade or business to another person generally are required to report such payments of $600 or more to the Internal Revenue Service (IRS). However, reporting may not be required in some circumstances involving the purchase of a life insurance contract.

Reasons for Change

Recent years have seen a significant increase in the number and size of life settlement transactions, wherein individuals sell previously-issued life insurance contracts to investors. Compliance is sometimes hampered by a lack of information reporting. In addition, the current law exceptions to the transfer-for-value rule may give investors the ability to structure a transaction to avoid paying tax on the profit when the insured person dies.

Proposal

The proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

The proposal also would modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The proposal would apply to sales or assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2012.

MODIFY PRORATION RULES FOR LIFE INSURANCE COMPANY GENERAL AND SEPARATE ACCOUNTS

Current Law

Corporate taxpayers may generally qualify for a dividends-received deduction (DRD) with regard to dividends received from other domestic corporations, in order to prevent or limit taxable inclusion of the same income by more than one corporation. No DRD is allowed, however, in respect of any dividend on any share of stock (1) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property, or (2) that is held by the taxpayer for 45 days or less during the 91-day period beginning on the date that is 45 days before the share becomes ex-dividend with respect to the dividend. For this purpose, the taxpayer's holding period is reduced for any period in which the taxpayer has diminished its risk of loss by holding one or more positions with respect to substantially similar or related property.

In the case of a life insurance company, the DRD is permitted only with regard to the "company's share" of dividends received, reflecting the fact that some portion of the company's dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The regime for computing the company's share and policyholders' share of net investment income is sometimes referred to as proration.

The policyholders' share equals 100 percent less the company's share, whereas the latter is equal to the company's share of net investment income divided by net investment income. The company's share of net investment income is the excess, if any, of net investment income over certain amounts, including "required interest," that are set aside to satisfy obligations to policyholders. Required interest with regard to an account is calculated by multiplying a specified account earnings rate by the mean of the reserves with regard to the account for the taxable year.

A life insurance company's separate account assets, liabilities, and income are segregated from those of the company's general account in order to support variable life insurance and variable annuity contracts. A company's share and policyholders' share are computed for the company's general account and separately for each separate account.

Reasons for Change

The proration methodology currently used by some taxpayers may produce a company's share that greatly exceeds the company's economic interest in the net investment income earned by its separate account assets, generating controversy between life insurance companies and the Internal Revenue Service. The purposes of the proration regime would be better served, and life insurance companies would be treated more like other taxpayers with a diminished risk of loss in stock or an obligation to make related payments with respect to dividends, if the company's share bore a more direct relationship to the company's actual economic interest in the account.

Proposal

The proposal would repeal the existing regime for prorating investment income between the "company's share" and the "policyholders' share." The general account DRD, tax-exempt interest, and increases in certain policy cash values of a life insurance company would instead be subject to a fixed 15 percent proration in a manner similar to that which applies under current law to non-life insurance companies. The limitations on DRD that apply to other corporate taxpayers would be expanded to apply explicitly to life insurance company separate account dividends in the same proportion as the mean of reserves bears to the mean of total assets of the account. The proposal would thus put the company's general account DRD on a similar footing to that of a non-life company, and would put its separate account DRD on a similar footing to that of any other taxpayer with a diminished risk of loss in stock that it owns, or with an obligation to make related payments with regard to dividends.

The proposal would be effective for taxable years beginning after December 31, 2012.

EXPAND PRO RATA INTEREST EXPENSE DISALLOWANCE FOR CORPORATE-OWNED LIFE INSURANCE

Current Law

In general, no Federal income tax is imposed on a policyholder with respect to the earnings credited under a life insurance or endowment contract, and Federal income tax generally is deferred with respect to earnings under an annuity contract (unless the annuity contract is owned by a person other than a natural person). In addition, amounts received under a life insurance contract by reason of the death of the insured generally are excluded from gross income of the recipient.

Interest on policy loans or other indebtedness with respect to life insurance, endowment, or annuity contracts generally is not deductible, unless the insurance contract insures the life of a key person of the business. A key person includes a 20-percent owner of the business, as well as a limited number of the business' officers or employees. However, this interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment, or annuity contract.

In addition, the interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values based on a statutory formula. An exception to the pro rata interest disallowance applies with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. In the case of both life and non-life insurance companies, special proration rules similarly require adjustments to prevent or limit the funding of tax-deductible reserve increases with tax preferred income, including earnings credited under life insurance, endowment, and annuity contracts that would be subject to the pro rata interest disallowance rule if owned by a non-insurance company.

Reasons for Change

Leveraged businesses can fund deductible interest expenses with tax-exempt or tax-deferred income credited under life insurance, endowment, or annuity contracts insuring certain types of individuals. For example, these businesses frequently invest in investment-oriented insurance policies covering the lives of their employees, officers, directors, or owners. These entities generally do not take out policy loans or other indebtedness that is secured or otherwise traceable to the insurance contracts. Instead, they borrow from depositors or other lenders, or issue bonds. Similar tax arbitrage benefits result when insurance companies invest in certain insurance contracts that cover the lives of their employees, officers, directors, or 20-percent shareholders and fund deductible reserves with tax-exempt or tax-deferred income.

Proposal

The proposal would repeal 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.

The proposal would apply to contracts issued after December 31, 2012, in taxable years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract would be treated as a new contract except that in the case of a master contract, the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

ELIMINATE FOSSIL FUEL PREFERENCES

Eliminate Oil and Gas Preferences

REPEAL ENHANCED OIL RECOVERY (EOR) CREDIT

Current Law

The general business credit includes a 15-percent credit for eligible costs attributable to EOR projects. If the credit is claimed with respect to eligible costs, the taxpayer's deduction (or basis increase) with respect to those costs is reduced by the amount of the credit. Eligible costs include the cost of constructing a gas treatment plant to prepare Alaska natural gas for pipeline transportation and any of the following costs with respect to a qualified EOR project: (1) the cost of depreciable or amortizable tangible property that is an integral part of the project; (2) intangible drilling and development costs (IDCs) that the taxpayer can elect to deduct; and (3) deductible tertiary injectant costs. A qualified EOR project must be located in the United States and must involve the application of one or more of nine listed tertiary recovery methods that can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which ultimately will be recovered. The allowable credit is phased out over a $6 range for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds an inflation adjusted threshold. The credit was completely phased out for taxable years beginning in 2011, because the reference price ($74.71) exceeded the inflation adjusted threshold ($42.91) by more than $6.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the credit must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The proposal would repeal the investment tax credit for enhanced oil recovery projects for taxable years beginning after December 31, 2012.

REPEAL CREDIT FOR OIL AND GAS PRODUCED FROM MARGINAL WELLS

Current Law

The general business credit includes a credit for crude oil and natural gas produced from marginal wells. The credit rate is $3.00 per barrel of oil and 50 cents per 1,000 cubic feet of natural gas for taxable years beginning in 2005 and is adjusted for inflation in taxable years beginning after 2005. The credit is available for production from wells that produce oil and gas qualifying as marginal production for purposes of the percentage depletion rules or that have average daily production of not more than 25 barrel-of-oil equivalents and produce at least 95 percent water. The credit per well is limited to 1,095 barrels of oil or barrel-of-oil equivalents per year. The credit rate for crude oil is phased out for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are $3.00 and $15.00 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit rate for natural gas is similarly phased out for a taxable year if the annual average wellhead price for domestic natural gas exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are 33 cents and $1.67 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit has been completely phased out for all taxable years since its enactment. Unlike other components of the general business credit, which can be carried back only one year, the marginal well credit can be carried back up to five years.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the credit must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The proposal would repeal the production tax credit for oil and gas from marginal wells for production in taxable years beginning after December 31, 2012.

REPEAL EXPENSING OF INTANGIBLE DRILLING COSTS (IDCS)

Current Law

In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale.

Special rules apply to IDCs. IDCs include all expenditures made by an operator (i.e., a person who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) for wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and amounts properly allocable to the cost of depreciable property) done by contractors under any form of contract (including a turnkey contract). IDCs include amounts paid for labor, fuel, repairs, hauling, and supplies which are used in the drilling, shooting, and cleaning of wells; in such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings) or items which are part of the acquisition price of an interest in the property.

Under the special rules applicable to IDCs, an operator who pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs. The uniform capitalization rules do not apply to otherwise deductible IDCs.

If a taxpayer elects to expense IDCs, the amount of the IDCs is deductible as an expense in the taxable year the cost is paid or incurred. Generally, IDCs that a taxpayer elects to capitalize may be recovered through depletion or depreciation, as appropriate; or in the case of a nonproductive well ("dry hole"), the operator may elect to deduct the costs. In the case of an integrated oil company (i.e., a company that engages, either directly or through a related enterprise, in substantial retailing or refining activities) that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.

A taxpayer that has elected to deduct IDCs may, nevertheless, elect to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate IDC adjustments or preferences under the alternative minimum tax.

The election to deduct IDCs applies only to those IDCs associated with domestic properties. For this purpose, the United States includes certain wells drilled offshore.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The expensing of IDCs, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Capitalization of IDCs would place the oil and gas industry on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

The proposal would repeal expensing of intangible drilling costs and 60-month amortization of capitalized intangible drilling costs. Intangible drilling costs would be capitalized as depreciable or depletable property, depending on the nature of the cost incurred, in accordance with the generally applicable rules.

The proposal would be effective for costs paid or incurred after December 31, 2012.

REPEAL DEDUCTION FOR TERTIARY INJECTANTS

Current Law

Taxpayers are allowed to deduct the cost of qualified tertiary injectant expenses for the taxable year. Qualified tertiary injectant expenses are amounts paid or incurred for any tertiary injectants (other than recoverable hydrocarbon injectants) that are used as a part of a tertiary recovery method to increase the recovery of crude oil. The deduction is treated as an amortization deduction in determining the amount subject to recapture upon disposition of the property.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The deduction for tertiary injectants, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Capitalization of tertiary injectants would place the oil and gas industry on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

The proposal would repeal the deduction for qualified tertiary injectant expenses for amounts paid or incurred after December 31, 2012.

REPEAL EXCEPTION TO PASSIVE LOSS LIMITATION FOR WORKING INTERESTS IN OIL AND NATURAL GAS PROPERTIES

Current Law

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Suspended deductions and credits are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses and credits from a passive activity are allowed in full when the taxpayer completely disposes of the activity.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. An exception is provided, however, for any working interest in an oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The special tax treatment of working interests in oil and gas properties, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the working interest exception for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Eliminating the working interest exception would subject oil and gas properties to the same limitations as other activities and reduce economic distortions.

Proposal

The proposal would repeal the exception from the passive loss rules for working interests in oil and gas properties for taxable years beginning after December 31, 2012.

REPEAL PERCENTAGE DEPLETION FOR OIL AND NATURAL GAS WELLS

Current Law

The capital costs of oil and gas wells are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis.

A taxpayer may also qualify for percentage depletion with respect to oil and gas properties. The amount of the deduction is a statutory percentage of the gross income from the property. For oil and gas properties, the percentage ranges from 15 to 25 percent and the deduction may not exceed 100 percent of the taxable income from the property (determined before the deductions for depletion and domestic manufacturing). In addition, the percentage depletion deduction for oil and gas properties may not exceed 65 percent of the taxpayer’s overall taxable income (determined before the deduction for depletion and with certain other adjustments).

Other limitations and special rules apply to the percentage depletion deduction for oil and gas properties. In general, only independent producers and royalty owners (in contrast to integrated oil companies) qualify for the percentage depletion deduction. In addition, oil and gas producers may claim percentage depletion only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (applied on a combined basis in the case of taxpayers that produce both). This quantity limitation is allocated, at the taxpayer’s election, between oil production and gas production and then further allocated within each class among the taxpayer’s properties. Special rules apply to oil and gas production from marginal wells (generally, wells for which the average daily production is less than 15 barrels of oil or barrel-of-oil equivalents or that produce only heavy oil). Only marginal well production can qualify for percentage depletion at a rate of more than 15 percent. The rate is increased in a taxable year that begins in a calendar year following a calendar year during which the annual average unregulated wellhead price per barrel of domestic crude oil is less than $20. The increase is one percentage point for each whole dollar of difference between the two amounts. In addition, marginal wells are exempt from the 100-percent-of-net-income limitation described above in taxable years beginning during the period 1998-2007 and in taxable years beginning during the period 2009-2011. Unless the taxpayer elects otherwise, marginal well production is given priority over other production in applying the 1,000-barrel limitation on percentage depletion.

A qualifying taxpayer determines the depletion deduction for each oil and gas property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer’s basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. Percentage depletion effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Cost depletion computed by reference to the taxpayer's basis in the property is the equivalent of economic depreciation. Limiting oil and gas producers to cost depletion would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

The proposal would repeal percentage depletion with respect to oil and gas wells. Taxpayers would be permitted to claim cost depletion on their adjusted basis, if any, in oil and gas wells.

The proposal would be effective for taxable years beginning after December 31, 2012.

INCREASE GEOLOGICAL AND GEOPHYSICAL AMORTIZATION PERIOD FOR INDEPENDENT PRODUCERS TO SEVEN YEARS

Current Law

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. The amortization period for geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States is two years for independent producers and seven years for integrated oil and gas producers.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The accelerated amortization of geological and geophysical expenditures incurred by independent producers, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and cutting carbon pollution. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Increasing the amortization period for geological and geophysical expenditures incurred by independent oil and gas producers from two years to seven years would provide a more accurate reflection of their income and more consistent tax treatment for all oil and gas producers.

Proposal

The proposal would increase the amortization period from two years to seven years for geological and geophysical expenditures incurred by independent producers in connection with all oil and gas exploration in the United States. Seven-year amortization would apply even if the property is abandoned and any remaining basis of the abandoned property would be recovered over the remainder of the seven-year period.

The proposal would be effective for amounts paid or incurred after December 31, 2012.

Eliminate Coal Preferences

REPEAL EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS

Current Law

In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale.

Special rules apply in the case of mining exploration and development expenditures. A taxpayer may elect to expense the exploration costs incurred for the purpose of ascertaining the existence, location, extent, or quality of an ore or mineral deposit, including a deposit of coal or other hard-mineral fossil fuel. Exploration costs that are expensed are recaptured when the mine reaches the producing stage either by a reduction in depletion deductions or, at the election of the taxpayer, by an inclusion in income in the year in which the mine reaches the producing stage.

After the existence of a commercially marketable deposit has been disclosed, costs incurred for the development of a mine to exploit the deposit are deductible in the year paid or incurred unless the taxpayer elects to deduct the costs on a ratable basis as the minerals or ores produced from the deposit are sold.

In the case of a corporation that elects to deduct exploration costs in the year paid or incurred, 30 percent of the otherwise deductible costs must be capitalized and amortized over a 60-month period. In addition, a taxpayer that has elected to deduct exploration costs may, nevertheless, elect to capitalize and amortize those costs over a 10-year period. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its exploration costs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate adjustments or preferences for exploration costs under the alternative minimum tax. Similar rules limiting corporate deductions and providing for 60-month and 10-year amortization apply with respect to mine development costs.

The election to deduct exploration costs and the rule making development costs deductible in the year paid or incurred apply only with respect to domestic ore and mineral deposits.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The expensing of exploration and development costs relating to coal and other hard-mineral fossil fuels, like other fossil-fuel preferences the Administration proposes to repeal, distorts markets by encouraging more investment in fossil-fuel production than would occur under a neutral system. This market distortion is inconsistent with the Administration's policy of supporting a clean energy economy and cutting carbon pollution. Moreover, the tax subsidy for coal and other hard-mineral fossil fuels must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Capitalization of exploration and development costs relating to coal and other hard-mineral fossil fuels would place taxpayers in that industry on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

The proposal would repeal expensing, 60-month amortization, and 10-year amortization of exploration and development costs with respect to coal and other hard-mineral fossil fuels. The costs would be capitalized as depreciable or depletable property, depending on the nature of the cost incurred, in accordance with the generally applicable rules. The other hard-mineral fossil fuels for which expensing, 60-month amortization, and 10-year amortization would not be allowed include lignite and oil shale to which a 15-percent depletion rate applies.

The proposal would be effective for costs paid or incurred after December 31, 2012.

REPEAL PERCENTAGE DEPLETION FOR HARD MINERAL FOSSIL FUELS

Current Law

The capital costs of coal mines and other hard-mineral fossil-fuel properties are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis.

A taxpayer may also qualify for percentage depletion with respect to coal and other hard-mineral fossil-fuel properties. The amount of the deduction is a statutory percentage of the gross income from the property. The percentage is 10 percent for coal and lignite and 15 percent for oil shale (other than oil shale to which a 7 ½ percent depletion rate applies because it is used for certain nonfuel purposes). The deduction may not exceed 50 percent of the taxable income from the property (determined before the deductions for depletion and domestic manufacturing).

A qualifying taxpayer determines the depletion deduction for each property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. Percentage depletion effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other fossil-fuel preferences the Administration proposes to repeal, distorts markets by encouraging more investment in fossil-fuel production than would occur under a neutral system. This market distortion is inconsistent with the Administration's policy of supporting a clean energy economy and cutting carbon pollution. Moreover, the tax subsidy for coal and other hard-mineral fossil fuels must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Cost depletion computed by reference to the taxpayer's basis in the property is the equivalent of economic depreciation. Limiting fossil-fuel producers to cost depletion would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

The proposal would repeal percentage depletion with respect to coal and other hard-mineral fossil fuels. The other hard-mineral fossil fuels for which no percentage depletion would be allowed include lignite and oil shale to which a 15-percent depletion rate applies. Taxpayers would be permitted to claim cost depletion on their adjusted basis, if any, in coal and other hard-mineral fossil-fuel properties.

The proposal would be effective for taxable years beginning after December 31, 2012.

REPEAL CAPITAL GAINS TREATMENT FOR ROYALTIES

Current Law

Royalties received on the disposition of coal or lignite generally qualify for treatment as long-term capital gain, and the royalty owner does not qualify for percentage depletion with respect to the coal or lignite. This treatment does not apply unless the taxpayer has been the owner of the mineral in place for at least one year before it is mined. The treatment also does not apply to income realized as a co-adventurer, partner, or principal in the mining of the mineral or to certain related-party transactions.

Reasons for Change

The President agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the United States can transition to a 21st-century energy economy. The capital gain treatment of coal and lignite royalties, like other fossil-fuel preferences the Administration proposes to repeal, distorts markets by encouraging more investment in fossil-fuel production than would occur under a neutral system. This market distortion is inconsistent with the Administration's policy of supporting a clean energy economy and cutting carbon pollution. Moreover, the tax subsidy for coal and lignite must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The proposal would repeal capital gains treatment of coal and lignite royalties and would tax those royalties as ordinary income.

The proposal would be effective for amounts realized in taxable years beginning after December 31, 2012.

OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS

INCREASE OIL SPILL LIABILITY TRUST FUND FINANCING RATE BY ONE CENT AND UPDATE THE LAW TO INCLUDE OTHER SOURCES OF CRUDES

Current Law

An excise tax is imposed on: (1) crude oil received at a U.S. refinery; (2) imported petroleum products (including crude oil) entered into the United States for consumption, use, or warehousing; and (3) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil. The tax is eight cents per barrel for periods before January 1, 2017, and 9 cents per barrel for periods after December 31, 2016. Crudes such as those that are produced from bituminous deposits as well as kerogen-rich rock are not treated as crude oil or petroleum products for purposes of the tax. The tax is deposited in the Oil Spill Liability Trust Fund to pay costs associated with oil removal and damages resulting from oil spills, as well as to provide annual funding to certain agencies for a wide range of oil pollution prevention and response programs, including research and development. In the case of an oil spill, the fund makes it possible for the Federal government to pay for removal costs up front, and then seek full reimbursement from the responsible parties.

Reasons for Change

The Deepwater Horizon oil spill was the worst oil spill in American history, releasing nearly 5 million barrels of oil into the Gulf of Mexico, and led to the nation's largest oil spill response. The magnitude of the Federal response reinforced the importance of the Oil Spill Liability Trust Fund and the need to maintain a sufficient balance, particularly in order to accommodate spills of national significance. In addition to increasing the rate of tax, it is appropriate to extend the tax to other sources of crudes that present environmental risks comparable to those associated with crude oil and petroleum products.

Proposal

The proposal would increase the rate of the Oil Spill Liability Trust Fund tax to 9 cents per barrel for periods after December 31, 2012, and to 10 cents per barrel for periods after December 31, 2016. In addition, the proposal would extend the tax to crudes such as those produced from bituminous deposits as well as kerogen-rich rock. The Superfund tax, which would be reinstated under a proposal discussed elsewhere in this volume, would also be imposed on these substances. The tax would be imposed at the applicable rate on such crudes received at a U.S. refinery, entered into the United States, or used or exported as described above after December 31, 2012.

REINSTATE AND EXTEND SUPERFUND EXCISE TAXES

Current Law

The following Superfund excise taxes were imposed before January 1, 1996:

(1) An excise tax on domestic crude oil and on imported petroleum products at a rate of 9.7 cents per barrel;

(2) An excise tax on listed hazardous chemicals at a rate that varied from 22 cents to $4.87 per ton; and

(3) An excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2) above.

Amounts equivalent to the revenues from these taxes were dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

Reasons for Change

The Superfund excise taxes should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances. In addition, it is appropriate to extend the tax to other crudes such as those produced from bituminous deposits as well as kerogen-rich rock.

Proposal

The proposal would reinstate the three Superfund excise taxes for periods after December 31, 2012 and before January 1, 2023. In addition, the proposal would extend the excise tax on domestic crude oil and imported petroleum products to other crudes such as those produced from bituminous deposits as well as kerogen-rich rock. Under a proposal discussed elsewhere in this volume, the Oil Spill Liability Trust Fund tax would also be imposed on these substances.

REINSTATE SUPERFUND ENVIRONMENTAL INCOME TAX

Current Law

For taxable years beginning before January 1, 1996, a corporate environmental income tax was imposed at a rate of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded $2 million. Modified alternative minimum taxable income was defined as a corporation's alternative minimum taxable income, determined without regard to the alternative tax net operating loss deduction and the deduction for the corporate environmental income tax.

The tax was dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

Reasons for Change

The corporate environmental income tax should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances where no viable, liable party has been identified.

Proposal

The proposal would reinstate the corporate environmental income tax for taxable years beginning after December 31, 2012 and before January 1, 2023.

MAKE UNEMPLOYMENT INSURANCE SURTAX PERMANENT

Current Law

The Federal Unemployment Tax Act (FUTA) currently imposes a Federal payroll tax on employers of 6.0 percent of the first $7,000 paid annually to each employee. The tax funds a portion of the Federal/State unemployment benefits system. States also impose an unemployment tax on employers. Employers in States that meet certain Federal requirements are allowed a credit for State unemployment taxes of up to 5.4 percent, making the minimum net Federal tax rate 0.6 percent. Generally, Federal and State unemployment taxes are collected quarterly and deposited in Federal trust fund accounts.

Before July 1, 2011, the Federal payroll tax had included a temporary surtax of 0.2 percent, which was added to the permanent FUTA tax rate. The surtax had been extended several times since its enactment in 1976, but it expired on July 1, 2011.

Reasons for Change

Reinstating the surtax will support the continued solvency of the Federal unemployment trust funds.

Proposal

The proposal would reinstate the 0.2 percent surtax and make it permanent.

The proposal would be effective for wages paid with respect to employment on or after January 1, 2013.

PROVIDE SHORT-TERM TAX RELIEF TO EMPLOYERS AND EXPAND FEDERAL UNEMPLOYMENT TAX ACT (FUTA) BASE

Current Law

The FUTA currently imposes a Federal payroll tax on employers of 6.0 percent of the first $7,000 paid annually to each employee. Generally, these funds support the administrative costs of the unemployment insurance (UI) benefits system. Employers in States that meet certain Federal requirements are allowed a credit against FUTA taxes of up to 5.4 percent, making the minimum net Federal rate 0.6 percent. States that become non-compliant are subject to a reduction in FUTA credit, causing employers to face a higher Federal UI tax.

Each State also imposes an unemployment insurance tax on employers to fund its State UI trust fund. State UI trust funds are used to pay unemployment benefits. When State trust funds are exhausted, States borrow from the Federal UI trust fund to pay for unemployment benefits. States that borrow from the Federal UI trust fund are required to pay back the borrowed amount including interest. This debt is partly repaid by increases in the Federal UI tax (reductions in the credit) on employers in these States.

Reasons for Change

In aggregate, States entered the recent recession with extremely low levels of reserves in their trust funds. Partly because of this, States have accrued large amounts of debt to the Federal UI trust fund. Employers in indebted States face immediate tax increases to repay these debts. These tax increases may discourage job creation at a time when growth is needed. At the same time, many States do not have a long-term plan to restore solvency to their trust funds. Short-term relief from State debt burdens coupled with longer-term increases in States' minimum taxable wage base will encourage economic growth and lead many States to more rapidly repay the debts they owe, restoring solvency to the UI system.

Proposal

The proposal would provide short-term relief to employers by suspending interest payments on State UI debt and suspending the FUTA credit reduction for employers in borrowing States in 2012 and 2013. The proposal would also raise the FUTA wage base in 2015 to $15,000 per worker paid annually, index the wage base to wage growth for subsequent years, and reduce the net Federal UI tax from 0.8 percent (after the proposed permanent reenactment and extension of the FUTA surtax) to 0.37 percent. States with wage bases below $15,000 would need to conform to the new FUTA base. States would maintain the ability to set their own tax rates, as under current law.

The proposal would be effective upon the date of enactment.

REPEAL LAST-IN, FIRST-OUT (LIFO) METHOD OF ACCOUNTING FOR INVENTORIES

Current Law

A taxpayer with inventory may determine the value of its inventory and its cost of goods sold using a number of different methods. The most prevalent method is the first-in, first-out (FIFO) method, which matches current sales with the costs of the earliest acquired (or manufactured) inventory items. As an alternative, a taxpayer may elect to use the LIFO method, which treats the most recently acquired (or manufactured) goods as having been sold during the year. The LIFO method can provide a tax benefit for a taxpayer facing rising inventory costs, since the cost of goods sold under this method is based on more recent, higher inventory values, resulting in lower taxable income. If inventory levels fall during the year, however, a LIFO taxpayer must include lower-cost LIFO inventory values (reflecting one or more prior-year inventory accumulations) in the cost of goods sold, and its taxable income will be correspondingly higher. To be eligible to elect LIFO for tax purposes, a taxpayer must use LIFO for financial accounting purposes.

Reasons for Change

The repeal of the LIFO method would eliminate a tax deferral opportunity available to taxpayers that hold inventories, the costs of which increase over time. In addition, LIFO repeal would simplify the Code by removing a complex and burdensome accounting method that has been the source of controversy between taxpayers and the Internal Revenue Service.

International Financial Reporting Standards do not permit the use of the LIFO method, and their adoption by the Securities and Exchange Commission would cause violations of the current LIFO book/tax conformity requirement. Repealing LIFO would remove this possible impediment to the implementation of these standards in the United States.

Proposal

The proposal would repeal the use of the LIFO inventory accounting method for Federal income tax purposes. Taxpayers that currently use the LIFO method would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2013. However, this one-time increase in gross income would be taken into account ratably over ten years, beginning with the first taxable year beginning after December 31, 2013.

REPEAL LOWER-OF- COST-OR-MARKET (LCM) INVENTORY ACCOUNTING METHOD

Current Law

Taxpayers required to maintain inventories are permitted to use a variety of methods to determine the cost of their ending inventories, including methods such as the last-in, first-out (LIFO) method, the first-in, first-out method, and the retail method. Taxpayers not using a LIFO method may: (1) write down the carrying values of their inventories by applying the LCM method instead of the cost method; and (2) write down the cost of "subnormal" goods (i.e., those that are unsalable at normal prices or unusable in the normal way because of damage, imperfection, or other similar causes).

Reasons for Change

The allowance of inventory write-downs under the LCM and subnormal goods provisions is an exception from the realization principle, and is essentially a one-way mark-to-market regime that understates taxable income. Thus, a taxpayer is able to obtain a larger cost-of-goods-sold deduction by writing down an item of inventory if its replacement cost falls below historical cost, but need not increase an item's inventory value if its replacement cost increases above historical cost. This asymmetric treatment is unwarranted. Also, the market value used under LCM for tax purposes generally is the replacement or reproduction cost of an item of inventory, not the item's net realizable value, as is required under generally accepted financial accounting rules. While the operation of the retail method is technically symmetric, it also allows retailers to obtain deductions for write-downs below inventory cost because of normal and anticipated declines in retail prices.

Proposal

The proposal would statutorily prohibit the use of the LCM and subnormal goods methods. Appropriate wash-sale rules also would be included to prevent taxpayers from circumventing the prohibition. The proposal would result in a change in the method of accounting for inventories for taxpayers currently using the LCM and subnormal goods methods, and any resulting section 481(a) adjustment generally would be included in income ratably over a four-year period beginning with the year of change.

The proposal would be effective for taxable years beginning after December 31, 2013.

ELIMINATE SPECIAL DEPRECIATION RULES FOR PURCHASES OF GENERAL AVIATION PASSENGER AIRCRAFT

Current Law

Under the depreciation rules, the recovery period for airplanes not used in commercial or contract carrying of passengers or freight (including corporate jets) generally is five years and the recovery period for airplanes and other assets (including ground property, but excluding helicopters) used in commercial or contract carrying of passengers or freight generally is seven years.

Reasons for Change

The shorter recovery period for depreciating airplanes not used in commercial or contract carrying of passengers or freight provides a tax preference for corporate jets and similar airplanes used primarily for transportation of passengers. To eliminate the preference for these airplanes over similar commercial transportation airplanes, their recovery periods should be harmonized.

Proposal

The proposal would define "general aviation passenger aircraft" to mean any airplane (including airframes and engines) not used in commercial or contract carrying of passengers or freight, but which primarily engages in the carrying of passengers (other than an airplane used primarily in emergency or emergency relief operations).

This proposal would increase the recovery period for depreciating general aviation passenger aircraft from five years to seven years. Correspondingly, for taxpayers using the alternative depreciation system, the recovery period for general aviation passenger aircraft would be extended to 12 years.

Any airplane not used in commercial or contract carrying of passengers or freight, but which is primarily engaged in non-passenger activities (e.g., crop dusting, firefighting, aerial surveying, etc.) and any helicopter would continue to be depreciated using a recovery period of five years (six years under the alternative depreciation system).

This proposal would be effective for property placed in service after December 31, 2012.

REPEAL GAIN LIMITATION FOR DIVIDENDS RECEIVED IN REORGANIZATION EXCHANGES

Current Law

Under section 356(a)(1), if as part of a reorganization transaction an exchanging shareholder receives in exchange for its stock of the target corporation both stock and property that cannot be received without the recognition of gain (often referred to as "boot"), the exchanging shareholder is required to recognize gain equal to the lesser of the gain realized in the exchange or the amount of boot received (commonly referred to as the "boot within gain" limitation). Further, under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's earnings and profits. The remainder of the gain (if any) is treated as gain from the exchange of property.

Reasons for Change

There is not a significant policy reason to vary the treatment of a distribution that otherwise qualifies as a dividend by reference to whether it is received in the normal course of a corporation's operations or is instead received as part of a reorganization exchange. Thus, repealing the boot-within-gain limitation for an exchange that has the effect of the distribution of a dividend will provide more uniform treatment for dividends that is less dependent on context. Moreover, in cross-border reorganizations, the boot-within-gain limitation can permit U.S. shareholders to repatriate previously-untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences. For example, if the exchanging shareholder's stock in the target corporation has little or no built-in gain at the time of the exchange, the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the corporation has previously untaxed earnings and profits equal to or greater than the boot. This result is inconsistent with the principle that previously untaxed earnings and profits of a foreign subsidiary should be subject to U.S. tax upon repatriation.

Proposal

The proposal would repeal the boot-within-gain limitation of current law in the case of any reorganization transaction if the exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2).

The proposal would be effective for taxable years beginning after December 31, 2012.

TAX CARRIED (PROFITS) INTERESTS AS ORDINARY INCOME

Current Law

A partnership is not subject to Federal income tax. Instead, an item of income or loss of the partnership retains its character and flows through to the partners, who must include such item on their tax returns. Generally, certain partners receive partnership interests in exchange for contributions of cash and/or property, while certain partners (not necessarily other partners) receive partnership interests, typically interests in future profits ("profits interests" or "carried interests"), in exchange for services. Accordingly, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, will reflect their shares of such gain on their tax returns as long-term capital gain. If the partner is an individual, such gain would be taxed at the reduced rates for long-term capital gains. Gain recognized on the sale of a partnership interest, whether it was received in exchange for property, cash, or services, is generally treated as capital gain.

Under current law, income attributable to a profits interest of a general partner is generally subject to self-employment tax, except to the extent the partnership generates types of income that are excluded from self-employment taxes, e.g., capital gains, certain interest, and dividends.

Reasons for Change

Although profits interests are structured as partnership interests, the income allocable to such interests is received in connection with the performance of services. A service provider's share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services. By allowing service partners to receive capital gains treatment on labor income without limit, the current system creates an unfair and inefficient tax preference. The recent explosion of activity among large private equity firms and hedge funds has increased the breadth and cost of this tax preference, with some of the highest-income Americans benefiting from the preferential treatment.

Proposal

The proposal would tax as ordinary income a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the character of the income at the partnership level. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains. In addition, the proposal would require the partner to pay self-employment taxes on such income. In order to prevent income derived from labor services from avoiding taxation at ordinary income rates, this proposal assumes that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain. To ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

An ISPI is a carried interest in an investment partnership that is held by a person who provides services to the partnership. A partnership is an investment partnership if substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those 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. To the extent (1) the partner who holds an ISPI contributes "invested capital" (which is generally money or other property) to the partnership, and (2) such partner's invested capital is a qualified capital interest (which generally requires that (a) the partnership allocations to the invested capital be in a same manner as allocations to other capital interests held by partners who do not hold an ISPI and (b) the allocations to these non-ISPI holders are significant), income attributable to the invested capital would not be recharacterized. Similarly, the portion of any gain recognized on the sale of an ISPI that is attributable to the invested capital would be treated as capital gain. However, "invested capital" will not include contributed capital that is attributable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership.

Also, any person who performs services for an entity and holds a "disqualified interest" in the entity is subject to tax at rates applicable to ordinary income on any income or gain received with respect to the interest. A "disqualified interest" is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation). This is an anti-abuse rule designed to prevent the avoidance of the proposal through the use of compensatory arrangements other than partnership interests. Other anti-abuse rules may be necessary.

The proposal is not intended to adversely affect qualification of a real estate investment trust owning a carried interest in a real estate partnership.

The proposal would be effective for taxable years ending after December 31, 2012.

EXPAND THE DEFINITION OF SUBSTANTIAL BUILT-IN LOSS FOR PURPOSES OF PARTNERSHIP LOSS TRANSFERS

Current Law

Under section 743(b), a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made an election under section 754 to make basis adjustments or the partnership has a substantial built-in loss. If an election is in effect or the partnership has a substantial built-in loss, adjustments are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest. These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

Prior to 2004, section 743(b) applied only if the partnership made an election under section 754. To prevent the duplication of losses, Congress amended section 743 to mandate section 743(b) adjustments if the partnership had a substantial built-in loss in its assets. Section 743(d) defines a substantial built-in loss by reference to the partnership's adjusted basis – that is, there is a substantial built-in loss if the partnership's adjusted basis in its assets exceeds by more than $250,000 the fair market value of such property.

Reasons for Change

Although the 2004 amendments to section 743 prevent the duplication of losses where the partnership has a substantial built-in loss in its assets, it does not prevent the duplication of losses where the transferee partner would be allocated a net loss in excess of $250,000 if the partnership sold all of its assets in a fully taxable transaction for fair market value, but the partnership itself does not have a substantial built-in loss in its assets.

Proposal

The proposal would amend section 743(d) to also measure a substantial built-in loss by reference to whether the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a full taxable transaction for cash equal to the fair market value of the assets.

The proposal would apply to sales or exchanges after the date of enactment.

EXTEND PARTNERSHIP BASIS LIMITATION RULES TO NONDEDUCTIBLE EXPENDITURES

Current Law

Section 704(d) provides that a partner's distributive share of loss is allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership year in which such loss occurred. Any excess is allowed as a deduction at the end of the partnership year in which the partner has sufficient basis in its partnership interest to take the deductions. Section 704(d) does not apply to partnership expenditures not deductible in computing partnership taxable income and not properly chargeable to capital account.

Reasons for Change

Even though a partner's distributive share of nondeductible expenditures reduces the partner's basis in its partnership interest, such items are not subject to section 704(d), and the partner may deduct or credit them currently even if the partner's basis in its partnership interest is zero.

Proposal

The proposal would amend section 704(d) to allow a partner's distributive share of expenditures not deductible in computing the partnership's taxable income and not properly chargeable to capital account only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership year in which such expenditure occurred.

The proposal would apply to a partnership's taxable year beginning on or after the date of enactment.

LIMIT THE IMPORTATION OF LOSSES UNDER SECTION 267(d)

Current Law

If a loss sustained by a transferor is disallowed under section 267(a)(1) or section 707(b)(1) because the transferor and transferee are related under section 267(b) or section 707(b)(1), section 267(d) provides that the transferee may reduce any gain the transferee later recognizes on a disposition of the transferred asset by the amount of the loss disallowed to the transferor. This has the effect of shifting the benefit of the loss from the transferor to the transferee.

Reasons for Change

Because section 267(d) shifts the benefit of the loss from the transferor to the transferee, losses can be imported where gain or loss with respect to the property is not subject to Federal income tax in the hands of the transferor immediately before the transfer but any gain or loss with respect to the property is subject to Federal income tax in the hands of the transferee immediately after the transfer.

The Proposal

The proposal would amend section 267(d) to provide that the principles of section 267(d) do not apply to the extent gain or loss with respect to the property is not subject to Federal income tax in the hands of the transferor immediately before the transfer but any gain or loss with respect to the property is subject to Federal income tax in the hands of the transferee immediately after the transfer.

The proposal would apply to transfers made after the date of enactment.

DENY DEDUCTION FOR PUNITIVE DAMAGES

Current Law

No deduction is allowed for a fine or similar penalty paid to a government for the violation of any law. If a taxpayer is convicted of a violation of the antitrust laws, or the taxpayer's plea of guilty or nolo contendere to such a violation is entered or accepted in a criminal proceeding, no deduction is allowed for two-thirds of any amount paid or incurred on a judgment or in settlement of a civil suit brought under section 4 of the Clayton Antitrust Act on account of such violation or any related antitrust violation. Where neither of these two provisions is applicable, a deduction is allowed for damages paid or incurred as ordinary and necessary expenses in carrying on any trade or business, regardless of whether such damages are compensatory or punitive.

Reasons for Change

The deductibility of punitive damage payments undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities.

Proposal

The proposal would disallow a deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, such damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report such payments to the insured person and to the Internal Revenue Service.

The proposal would apply to damages paid or incurred after December 31, 2013.

ELIMINATE THE DEDUCTION FOR CONTRIBUTIONS OF CONSERVATION EASEMENTS ON GOLF COURSES

Current Law

A deduction is generally available for charitable contributions of cash and property. This deduction is limited - or disallowed entirely - for certain types of hard-to-value property. In general, no charitable deduction is allowed for a contribution of a partial interest in property. An exception to this rule provides that a donor may deduct the value of a conservation easement (a partial interest) that is donated to a qualified charitable organization exclusively for conservation purposes. The value of the deduction for any contribution that produces a return benefit to the donor must be reduced by the value of the benefit received.

Reasons for Change

Recent court decisions have upheld large deductions taken for contributions of easements preserving recreational amenities, including golf courses, surrounded by upscale, private home sites. These contributions have raised concerns both that the deduction amounts claimed for such easements (often by the developers of the private home sites) are excessive, and also that the conservation easement deduction is not narrowly tailored to promote only bona fide conservation activities, as opposed to the private interests of donors. These concerns are particularly strong in the case of the deduction for contributions of easements on golf courses. The benefit of an easement on a private golf course, especially one that is part of a luxury housing development, may accrue to a limited number of users such as members of the course club or the owners of the surrounding homes, not the general public, and the construction and operation of the course may even result in environmental degradation. Easements on golf courses are particularly susceptible to overvaluation, as private interests often profit from the contribution of the easement. Because of the difficulty determining both the value of the easement and the value of the return benefits provided to the donor – including indirect benefits, such as the increase in the value of home sites surrounding the golf course – it is difficult and costly for the IRS to challenge inflated golf course easement deductions. Thus, to promote the kinds of public benefits intended by the charitable deduction provision and to prevent abuses, no charitable deduction should be allowed for contributions of easements on golf courses.

Proposal

The proposal would amend the charitable contribution deduction provision to prohibit a deduction for any contribution of property that is, or is intended to be, used as a golf course.

The proposal would be effective as of the date of enactment.

REDUCE THE TAX GAP AND MAKE REFORMS

Expand Information Reporting

REQUIRE INFORMATION REPORTING FOR PRIVATE SEPARATE ACCOUNTS OF LIFE INSURANCE COMPANIES

Current Law

Earnings from direct investment in securities generally result in taxable income to the holder. In contrast, investments in comparable assets through a separate account of a life insurance company generally give rise to tax-free or tax-deferred income. This favorable tax treatment for investing through a life insurance company is not available if the policyholder has so much control over the investments in the separate account that the policyholder, rather than the insurance company, is treated as the owner of those investments.

Reasons for Change

In some cases, private separate accounts are being used to avoid tax that would be due if the assets were held directly. Better reporting of investments in private separate accounts will help the Internal Revenue Service (IRS) to ensure that income is properly reported. Moreover, such reporting will enable the IRS to identify more easily which variable insurance contracts qualify as insurance contracts under current law and which contracts should be disregarded under the investor control doctrine.

Proposal

The proposal would require life insurance companies to report to the IRS, for each contract whose cash value is partially or wholly invested in a private separate account for any portion of the taxable year and represents at least 10 percent of the value of the account, the policyholder's taxpayer identification number, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that was invested in one or more private separate accounts. For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies whose cash values, in the aggregate, represent at least 10 percent of the value of the separate account. Whether a related group of persons owns policies whose cash values represent at least 10 percent of the value of the account would be determined quarterly, based on information reasonably within the issuer's possession.

The proposal would be effective for taxable years beginning after December 31, 2012.

REQUIRE A CERTIFIED TAXPAYER IDENTIFICATION NUMBER (TIN) FROM CONTRACTORS AND ALLOW CERTAIN WITHHOLDING

Current Law

In the course of a trade or business, service recipients ("businesses") making payments aggregating to $600 or more in a calendar year to any non-employee service provider ("contractor") that is not a corporation are required to send an information return to the Internal Revenue Service (IRS) setting forth the amount, as well as name, address, and TIN of the contractor. The information returns, required annually after the end of the year, are made on Form 1099-MISC based on identifying information furnished by the contractor but not verified by the IRS. Copies are provided both to the contractor and to the IRS. Withholding is not required or permitted for payments to contractors. Since contractors are not subject to withholding, they may be required to make quarterly payments of estimated income taxes and self-employment (SECA) taxes near the end of each calendar quarter. The contractor is required to pay any balance due when the annual income tax return is subsequently filed.

Reasons for Change

Without accurate taxpayer identifying information, information reporting requirements impose avoidable burdens on businesses and the IRS, and cannot reach their potential to improve compliance.

Estimated tax filing is relatively burdensome, especially for less sophisticated and lower-income taxpayers. Moreover, by the time estimated tax payments (or final tax payments) are due, some contractors will not have put aside the necessary funds. Given that the SECA tax rate is 15.3 percent (up to certain income limits), the required estimated tax payments can be more than 25 percent of a contractor's gross receipts, even for a contractor with modest income.

An optional withholding method for contractors would reduce the burdens of having to make quarterly payments, would help contractors automatically set aside funds for tax payments, and would help increase compliance.

Proposal

The proposal would require a contractor receiving payments of $600 or more in a calendar year from a particular business to furnish to the business (on Form W-9) the contractor's certified TIN. A business would be required to verify the contractor's TIN with the IRS, which would be authorized to disclose, solely for this purpose, whether the certified TIN-name combination matches IRS records. If a contractor failed to furnish an accurate certified TIN, the business would be required to withhold a flat-rate percentage of gross payments. Contractors receiving payments of $600 or more in a calendar year from a particular business could require the business to withhold a flat-rate percentage of their gross payments, with the flat-rate percentage of 15, 25, 30, or 35 percent being selected by the contractor.

The proposal would be effective for payments made to contractors after December 31, 2012.

Improve Compliance by Businesses

REQUIRE GREATER ELECTRONIC FILING OF RETURNS

Current Law

Corporations with assets of $10 million or more filing Form 1120 are required to file Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More). This Schedule M-3 filing requirement also applies to S corporations, life insurance corporations, property and casualty insurance corporations, and cooperative associations filing various versions of Form 1120 and having $10 million or more in assets. Schedule M-3 is also required for partnerships with assets of $10 million or more and certain other partnerships.

Corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, are required to file electronically their Form 1120/1120S income tax returns and Form 990 information returns. In addition, private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer. Although electronic filing is required of certain corporations and other taxpayers, others may convert voluntarily to electronic filing.

Generally, regulations may require electronic filing by taxpayers (other than individuals, estates and trusts) that file at least 250 returns annually. Before requiring electronic filing, the Internal Revenue Service (IRS) and Treasury Department must take into account the ability of taxpayers to comply at a reasonable cost.

Reasons for Change

Generally, compliance increases when taxpayers are required to provide better information to the IRS in usable form. Large organizations with assets of $10 million or more generally maintain financial records in electronic form, and generally either hire tax professionals who use tax preparation software or use tax preparation software themselves, although they may not currently file electronically.

Electronic filing supports the broader goals of improving IRS service to taxpayers, enhancing compliance, and modernizing tax administration. Overall, increased electronic filing of returns may improve customer satisfaction and confidence in the filing process, and may be more cost effective for affected entities. Expanding electronic filing to certain additional large entities will help provide tax return information in a more uniform electronic form. This will enhance the ability of the IRS to more productively focus its audit activities. This can reduce burdens on businesses where the need for an audit can be avoided.

In the case of a large business, adopting the same standard for electronic filing as for filing Schedule M-3 provides simplification benefits.

Proposal

The proposal would require all those corporations and partnerships that must file Schedule M-3 to file their tax returns electronically. In the case of certain other large taxpayers that are not required to file Schedule M-3 (such as exempt organizations), the regulatory authority to require electronic filing would be expanded to allow reduction of the current threshold of filing 250 or more returns during a calendar year. Additionally, the regulatory authority would be expanded to allow reduction of the 250-return threshold in the case of information returns such as those required by Subpart B, Part III, Subchapter A, Chapter 61, Subtitle F, of the Internal Revenue Code (generally Forms 1099, 1098, 1096, and 5498). Nevertheless, any new regulations would balance the benefits of electronic filing against any burden that might be imposed on taxpayers, and implementation would take place incrementally to afford adequate time for transition to electronic filing. Taxpayers would be able to request waivers of this requirement if they cannot meet the requirement due to technological constraints, if compliance with the requirement would result in undue financial burden, or if other criteria specified in regulations are met.

The proposal would be effective for taxable years ending after December 31, 2012.

AUTHORIZE THE DEPARTMENT OF THE TREASURY TO REQUIRE ADDITIONAL INFORMATION TO BE INCLUDED IN ELECTRONICALLY FILED FORM 5500 ANNUAL REPORTS

Current Law

Code section 6058 requires the sponsor of a funded plan of deferred compensation (or the administrator of the plan) to file an annual return containing certain information in accordance with regulations prescribed by the Secretary of the Treasury. Section 6059 requires that a pension plan subject to the minimum funding requirements of section 412 file an actuarial report prepared by an enrolled actuary. Similarly, Title I of the Employee Retirement Income Security Act of 1974 (ERISA) requires that certain pension and welfare benefit plans file an annual report disclosing certain information to the Department of Labor (DOL). These Code and ERISA filing requirements have been consolidated into a single series of forms (Form 5500 and attachments) that is filed with the DOL and then shared with the Internal Revenue Service (IRS). This filing serves as the primary tool for gathering information and for appropriate targeting of enforcement activity regarding such plans. It also serves to satisfy certain requirements for filing with the Pension Benefit Guaranty Corporation.

Reasons for Change

The Department of Labor has the authority to require electronic filing of information relevant to Title I of ERISA and has exercised its authority to require that Form 5500 and its attachments be filed electronically. However, under section 6011(e), the Treasury and IRS lack general statutory authority to require electronic filing of returns unless the person subject to the filing requirement must file at least 250 returns during the year. As a result, information relevant only to tax code requirements (such as data on coverage needed to test compliance with nondiscrimination rules) and not to DOL's ERISA Title I jurisdiction cannot be requested on the electronically-filed joint Form 5500 and currently is not collected. Collecting it would require a separate "IRS only" form that could be filed on paper, a process that would be neither simple nor efficient for taxpayers or for the IRS and DOL.

Proposal

The proposal would provide the IRS the authority to require in the electronically filed annual reports the inclusion of information that is relevant only to employee benefit plan tax requirements, giving the IRS authority with respect to such tax information comparable to that DOL already has with respect to information relevant to ERISA Title I.

The proposal would be effective for plan years beginning after December 31, 2012.

IMPLEMENT STANDARDS CLARIFYING WHEN EMPLOYEE LEASING COMPANIES CAN BE HELD LIABLE FOR THEIR CLIENTS' FEDERAL EMPLOYMENT TAXES

Current Law

Employers are required to withhold and pay Federal Insurance Contribution Act (FICA) taxes and to withhold and remit income taxes, and are required to pay Federal Unemployment Tax Act (FUTA) taxes (collectively "Federal employment taxes") with respect to wages paid to their employees. Liability for Federal employment taxes generally lies with the taxpayer that is determined to be the employer under a multi-factor common law test or under specific statutory provisions. For example, a third party that is not the common law employer can be a statutory employer if the third party has control over the payment of wages. In addition, certain designated agents are jointly and severally liable with their principals for employment taxes with respect to wages paid to the principals' employees. These designated agents prepare and file employment tax returns using their own name and employer identification number. In contrast, reporting agents (often referred to as payroll service providers) are generally not liable for the employment taxes reported on their clients' returns. Reporting agents prepare and file employment tax returns for their clients using the client's name and employer identification number.

Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Employee leasing companies (often referred to as professional employer organizations) typically prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of their clients' workers.

Reasons for Change

Under present law, there is often uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to wages paid by a taxpayer that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

Providing standards for when an employee leasing company and its clients will be held liable for Federal employment taxes will facilitate the assessment, payment, and collection of those taxes and will preclude taxpayers who have control over withholding and payment of those taxes from denying liability when the taxes are not paid.

Proposal

The proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also provide standards for holding employee leasing companies solely liable for such taxes if they meet specified requirements.

The provision would be effective for employment tax returns required to be filed with respect to wages paid after December 31, 2012.

INCREASE CERTAINTY WITH RESPECT TO WORKER CLASSIFICATION

Current Law

For both tax and nontax purposes, workers must be classified into one of two mutually exclusive categories: employees or self-employed (sometimes referred to as independent contractors).

Worker classification generally is based on a common-law test for determining whether an employment relationship exists. The main determinant is whether the service recipient (employer) has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result. For classification purposes, it does not matter whether the service recipient exercises that control, only that he or she has the right to exercise it. Even though it is generally recognized that more highly skilled workers may not require much guidance or direction from the service recipient, the underlying concept of the right to control is the same for them. In determining worker status, the Internal Revenue Service (IRS) looks to three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test: behavioral control, financial control, and the relationship of the parties.

For employees, employers are required to withhold income and Federal Insurance Contribution Act (FICA) taxes and to pay the employer's share of FICA taxes. Employers are also required to pay Federal Unemployment Tax Act (FUTA) taxes and generally state unemployment compensation taxes. Liability for Federal employment taxes and the obligation to report the wages generally lie with the employer.

For workers who are classified as independent contractors, service recipients engaged in a trade or business and making payments totaling $600 or more in a calendar year to an independent contractor that is not a corporation are required to send an information return to the IRS and to the independent contractor stating the total payments made during the year. The service recipient generally does not need to withhold taxes from the payments reported unless the independent contractor has not provided its taxpayer identification number to the service recipient. Independent contractors pay Self-Employment Contributions Act (SECA) tax on their net earnings from self-employment (which generally is equivalent to both the employer and employee shares of FICA tax). Independent contractors generally are required to pay their income tax, including SECA liabilities, by making quarterly estimated tax payments.

For workers, whether employee or independent contractor status is more beneficial depends on many factors including the extent to which an independent contractor is able to negotiate for gross payments that include the value of nonwage costs that the service provider would have to incur in the case of an employee. In some circumstances, independent contractor status is more beneficial; in other circumstances, employee status is more advantageous.

Under a special provision (section 530 of the Revenue Act of 1978 which was not made part of the Internal Revenue Code), a service recipient may treat a worker as an independent contractor for Federal employment tax purposes even though the worker actually may be an employee under the common law rules if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. The special provision applies only if (1) the service recipient has not treated the worker (or any worker in a substantially similar position) as an employee for any period beginning after 1977 and (2) the service recipient has filed all Federal tax returns, including all required information returns, on a basis consistent with treating the worker as an independent contractor.

If an employer meets the requirements for the special provision with respect to a class of workers, the IRS is prohibited from reclassifying the workers as employees, even prospectively and even as to newly hired workers in the same class. Since 1996, the IRS has considered the availability of the special provision as the first part of any examination concerning worker classification. If the IRS determines that the special provision applies to a class of workers, it does not determine whether the workers are in fact employees or independent contractors. Thus, the worker classification continues indefinitely even if it is incorrect.

The special provision also prohibits the IRS from issuing generally applicable guidance addressing the proper classification of workers. Current law and procedures also provide for reduced penalties for misclassification where the special provision is not available but where, among other things, the employer agrees to prospective reclassification of the workers as employees.

Reasons for Change

Since 1978, the IRS has not been permitted to issue general guidance addressing worker classification, and in many instances has been precluded from reclassifying workers – even prospectively – who may have been misclassified. Since 1978, there have been many changes in working relationships between service providers and service recipients. As a result, there has been continued and growing uncertainty about the correct classification of some workers.

Many benefits and worker protections are available only for workers who are classified as employees. Incorrect classification as an independent contractor for tax purposes may spill over to other areas and, for example, lead to a worker not receiving benefits for unemployment (unemployment insurance) or on-the-job injuries (workers' compensation), or not being protected by various on-the-job health and safety requirements.

The incorrect classification of workers also creates opportunities for competitive advantages over service recipients who properly classify their workers. Such misclassification may lower the service recipient's total cost of labor by avoiding workers' compensation and unemployment compensation premiums, and could also provide increased opportunities for noncompliance by service providers.

Workers, service recipients, and tax administrators would benefit from reducing uncertainty about worker classification, eliminating potential competitive advantages and incentives to misclassify workers associated with worker misclassification by competitors, and reducing opportunities for noncompliance by workers classified as self-employed, while maintaining the benefits and worker protections associated with an administrative and social policy system that is based on employee status.

Proposal

The proposal would permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law. The reduced penalties for misclassification provided under current law would be retained, except that lower penalties would apply only if the service recipient voluntarily reclassifies its workers before being contacted by the IRS or another enforcement agency and if the service recipient had filed all required information returns (Forms 1099) reporting the payments to the independent contractors. For service recipients with only a small number of employees and a small number of misclassified workers, even reduced penalties would be waived if the service recipient (1) had consistently filed Forms 1099 reporting all payments to all misclassified workers and (2) agreed to prospective reclassification of misclassified workers. It is anticipated that, after enactment, new enforcement activity would focus mainly on obtaining the proper worker classification prospectively, since in many cases the proper classification of workers may not have been clear. (Statutory employee or nonemployee treatment as specified under current law would be retained.)

The Department of the Treasury and the IRS also would be permitted to issue generally applicable guidance on the proper classification of workers under common law standards. This would enable service recipients to properly classify workers with much less concern about future IRS examinations. Treasury and the IRS would be directed to issue guidance interpreting common law in a neutral manner recognizing that many workers are, in fact, not employees. Further, Treasury and the IRS would develop guidance that would provide safe harbors and/or rebuttable presumptions, both narrowly defined. To make that guidance clearer and more useful for service recipients, it would generally be industry- or job-specific. Priority for the development of guidance would be given to industries and jobs in which application of the common law test has been particularly problematic, where there has been a history of worker misclassification, or where there have been failures to report compensation paid.

Service recipients would be required to give notice to independent contractors, when they first begin performing services for the service recipient, that explains how they will be classified and the consequences thereof, e.g., tax implications, workers' compensation implications, wage and hour implications.

The IRS would be permitted to disclose to the Department of Labor information about service recipients whose workers are reclassified.

To ease compliance burdens for independent contractors, 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, with the flat rate percentage being selected by the contractor.

The proposal would be 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.

REPEAL SPECIAL ESTIMATED TAX PAYMENT PROVISION FOR CERTAIN INSURANCE COMPANIES

Current Law

An insurance company uses reserve accounting to compute losses incurred. That is, losses incurred for the taxable year includes losses paid during the taxable year (net of salvage and reinsurance recovered), plus or minus the increase or decrease in discounted unpaid losses during the year. An adjustment is also made for the change in discounted estimated salvage and reinsurance recoverable.

Unpaid losses are determined on a discounted basis to account for the time that may elapse between an insured loss event and the payment or other resolution of the claim. Taxpayers may, however, elect under section 847 to take an additional deduction equal to the difference between the amount of their reserves computed on a discounted basis and the amount computed on an undiscounted basis. In order to do so, a taxpayer must make a special estimated tax payment (SETP) equal to the tax benefit attributable to the additional deduction. In addition, the additional deductions are added to a special loss discount account. In future years, as losses are paid, amounts are subtracted from the special discount account and included in gross income; the SETPs are used to offset tax generated by these income inclusions. To the extent an amount added to the special loss discount account is not subtracted within 15 years, it is automatically subtracted (and included in gross income) for the 15th year. This regime of additional deductions and SETPs is, by design, revenue neutral.

Reasons for Change

Although this provision is revenue neutral, it imposes a substantial recordkeeping burden on both taxpayers and the Internal Revenue Service. Records must be maintained for up to 15 years for both amounts added to the special loss discount account and amounts paid as SETPs. Additional complexities frequently arise, such as when a taxpayer has a net operating loss carryback, or when a taxpayer is subject to regular tax in one year and alternative minimum tax in another. Also, further complexity arises under section 847 because an insurance company must account for tax benefits that would arise from the filing of a consolidated return with other insurance companies without taking into account statutory limitations on the absorption of losses of non-life insurers against income of life insurance companies.

Proposal

The proposal would repeal section 847 of the Internal Revenue Code, effective for taxable years beginning after December 31, 2012.

The entire balance of any existing special loss discount account would be included in gross income for the first taxable year beginning after December 31, 2012, and the entire amount of existing SETPs would be applied against additional tax that is due as a result of that inclusion. Any SETPs in excess of the additional tax that is due would be treated as an estimated tax payment under section 6655.

In lieu of immediate inclusion in gross income for the first taxable year beginning after December 31, 2012, taxpayers would be permitted to elect to include the balance of any existing special loss discount account in gross income ratably over a four taxable year period, beginning with the first taxable year beginning after December 31, 2012. During this period, taxpayers would be permitted to use existing SETPs to offset any additional tax that is due as a result of that inclusion. At the end of the fourth year, any remaining SETPs would be treated as an estimated tax payment under section 6655.

ELIMINATE SPECIAL RULES MODIFYING THE AMOUNT OF ESTIMATED TAX PAYMENTS BY CORPORATIONS

Current Law

Under section 6655 of the Internal Revenue Code, corporations generally are required to pay their income tax liability for a taxable year in quarterly estimated payments. For corporations that keep their accounts on a calendar year basis, these payments are generally due on or before April 15, June 15, September 15, and December 15 of the particular taxable year. The amount due each quarter is generally one-quarter (25 percent) of the amount due for the year.

A number of acts have modified the standard rules as to the amount due by "large corporations" for a particular quarter. A large corporation, for this purpose, means a corporation with assets of $1 billion or more, determined as of the end of the preceding taxable year. For example, Public Law 111-210, which renewed import restrictions under the Burmese Freedom and Democracy Act of 2003, increased the quarterly estimated tax payment required by large corporations for July, August, or September 2015, to 121.75 percent of the amount otherwise due. Where the amount required for a particular quarter has been increased, the amount of the next required quarterly payment is reduced accordingly.

Reasons for Change

The frequent changes to the corporate estimated tax payment schedule do not generally increase a corporation's income tax liability for a particular taxable year. However, the frequency of such changes operates to increase uncertainty within the corporate tax system.

Proposal

The proposal would repeal all legislative acts that cause the amount and timing of corporate estimated payments to differ from the rules described under section 6655.

The proposal would be effective for taxable years beginning after December 31, 2012.

Strengthen Tax Administration

STREAMLINE AUDIT AND ADJUSTMENT PROCEDURES FOR LARGE PARTNERSHIPS

Current Law

The Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) established unified audit rules applicable to all but certain small partnerships.

These rules require the tax treatment of all “partnership items” to be determined at the partnership, rather than the partner, level. The rules also require a partner to report all partnership items consistently with the partnership return, unless the partner notifies the IRS of any inconsistency. The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Nevertheless, the IRS must still assess any resulting adjustment against each of the taxpayers who were partners in the year in which the misstatement of tax liability arose. In addition, any partner can request an administrative adjustment or a refund for his own separate tax liability and participate in partnership-level administrative proceedings. The TEFRA partnership rules also require the IRS to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than 1 percent.

Because “[the TEFRA] audit and adjustment procedures for large partnerships are inefficient and more complex than those for other large entities,”[12] the Taxpayer Relief Act of 1997 established streamlined audit and adjustment procedure, as well as a simplified reporting system, for electing large partnerships (“ELPs”), which are generally defined as partnerships that have 100 or more partners during the preceding taxable year and elect to be treated as an ELP.

Under the streamlined ELP audit and adjustment procedures, the IRS generally makes adjustments at the partnership level that flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners’ share of current-year partnership items of income, gains, losses, deductions, or credits are adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner’s distributive shares). Unlike the TEFRA partnership rules, only the partnership can request a refund and the partners of an ELP do not have the right to participate in partnership-level administrative proceedings. Under the ELP audit rules, the IRS need not give notice to individual partners of the beginning of an administrative proceeding or of a final adjustment. Instead, a notice of partnership adjustments is generally sent to the partnership, and only the partner designated by the partnership may act on behalf of the partnership. In addition, the ELP regime allows for simplified reporting to the IRS.

[12] House Conference Report No. 105-220.

Reason for Change

The present TEFRA partnership audit and adjustment procedures for large partnerships remain inefficient and more complex than those applicable to other large entities. Although the ELP regime was enacted to mitigate the problem, few large partnerships have elected into the ELP regime. In addition, there has been substantial growth in the number and complexity of large partnerships, magnifying the difficulty of auditing large partnerships under the TEFRA partnership procedures.

Proposal

The proposal would mandate the streamlined ELP audit and adjustment procedures, but not the simplified reporting, for any partnership that has 1,000 or more partners at any time during the taxable year, a "Required Large Partnership" (RLP).

An RLP, like an ELP, would not include any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform those services; (2) retired partners who had performed those services; or (3) spouses of partners who had performed those services.

An RLP will continue to be treated as an RLP unless it can demonstrate that the number of partners fell below the 1,000 partner threshold for the 60-month period ending with the last day of its most recently ended taxable year. An RLP, however, may elect to continue to be an RLP. In addition, a partnership that has 100 or more partners at any time during the taxable year may elect to be an RLP. If a partnership makes an election provided for in the prior two sentences, the election cannot be revoked for any year without the consent of the Secretary.

For purposes of determining whether a partnership has 1,000 or more partners, any person that owns an interest directly or indirectly in the partnership through one or more pass-thru partners (as defined in section 6231(a)(9)) is treated as a partner. The proposal would require any partnership, estate, trust, S corporation, nominee, or other similar person ("pass-thru person") that owns a direct interest in another pass-thru person ("lower-tier pass-thru person") to provide to the lower-tier pass-thru person the information necessary for the lower-tier pass-thru person to determine the number of owners that the pass-thru person has. A pass-thru person and a lower-tier pass-thru person may agree that the pass-thru person need not provide the above information to the lower-tier pass-thru person if the parties determine the information is not necessary to determine that the lower-tier partnership has 1,000 or more partners.

The partnership would be required to certify that it had at least 1,000 partners at some time during the taxable year by filing an RLP return. The treatment provided by the certification would be binding on the partnership, all partners of the partnership, and on the IRS. Thus, if a partnership incorrectly filed an RLP return, the RLP procedures would continue to apply for that taxable year. Conversely, if a partnership incorrectly failed to file an RLP return, the TEFRA partnership audit procedures would continue to apply to the partnership for that taxable year. The proposal, however, would provide that if a partnership incorrectly failed to file an RLP return, the period of limitations on assessment would not expire before the date that is 3 years after the date that the Secretary determined that an RLP return should have been filed. This would allow the IRS sufficient time to carry out the TEFRA partnership procedures. In addition, the partnership would be treated as an RLP for the partnership's taxable year ending on or after the date the Secretary determines and notifies the partnership that an RLP return should have been filed. For example, if on June 1, 2016, the Secretary determines and notifies a calendar-year partnership that it incorrectly failed to file an RLP return for its 2014 taxable year, the partnership would be treated as an RLP for its taxable year ending December 31, 2016.

If a partnership incorrectly failed to file the proper return, a penalty will be imposed on the partnership equal to the product of $5,000 multiplied by the number of direct and indirect partners of the partnership. The partnership would be liable for any penalty imposed by this provision. No penalty will be imposed if the partnership establishes that there was reasonable cause for, and the partnership acted in good faith with respect to, incorrectly failing to file the proper return.

The proposal would also make simplifying changes to the existing ELP regime. The proposal would eliminate the requirement that an ELP provide information returns to its partners within 2 ½ months following the close of its taxable year and, instead, require the information returns be provided by the time required for non-ELP partnerships. Additionally, the definition of an ELP would be amended to provide that the number of persons who were partners in the partnership must equal or exceed 100 at any time during the partnership taxable year, as opposed to in the preceding partnership taxable year.

The proposal would allow the Secretary to promulgate regulations to further define these rules, including rules to ensure that taxpayers do not transfer partnership interests with a principal purpose of utilizing the RLP regime to alter the taxpayers' aggregate tax liability, and rules to address foreign pass-thru partners including, where appropriate, treating a foreign pass-thru partner that is a partnership as an RLP.

The proposal would apply to a partnership's taxable year ending on or after the date that is two years from the date of enactment.

REVISE OFFER-IN-COMPROMISE APPLICATION RULES

Current Law

Current law provides that the Internal Revenue Service (IRS) may compromise any civil or criminal case arising under the internal revenue laws prior to a reference to the Department of Justice for prosecution or defense. In 2006, a new provision was enacted to require taxpayers to make certain nonrefundable payments with any initial offer-in-compromise of a tax case. The new provision requires taxpayers making a lump-sum offer-in-compromise to include a nonrefundable payment of 20 percent of the lump-sum with the initial offer. In the case of an offer-in-compromise involving periodic payments, the initial offer must be accompanied by a nonrefundable payment of the first installment that would be due if the offer were accepted.

Reasons for Change

Requiring nonrefundable payments with an offer-in-compromise may substantially reduce access to the offer-in-compromise program. The offer-in-compromise program is designed to settle cases in which taxpayers have demonstrated an inability to pay the full amount of a tax liability. The program allows the IRS to collect the portion of a tax liability that the taxpayer has the ability to pay. Reducing access to the offer-in-compromise program makes it more difficult and costly to obtain the collectable portion of existing tax liabilities.

Proposal

The proposal would eliminate the requirements that an initial offer-in-compromise include a nonrefundable payment of any portion of the taxpayer's offer.

The proposal would be effective for offers-in-compromise submitted after the date of enactment.

EXPAND INTERNAL REVENUE SERVICE (IRS) ACCESS TO INFORMATION IN THE NATIONAL DIRECTORY OF NEW HIRES FOR TAX ADMINISTRATION PURPOSES

Current Law

The Office of Child Support Enforcement of the Department of Health and Human Services maintains the National Directory of New Hires (NDNH), which is a database that contains data from Form W-4 for newly-hired employees, quarterly wage data from State workforce and Federal agencies for all employees, and unemployment insurance data from State workforce agencies for all individuals who have applied for or received unemployment benefits. The NDNH was created to help State child support enforcement agencies enforce obligations of parents across State lines.

Under current provisions of the Social Security Act, the IRS may obtain data from the NDNH, but only for the purpose of administering the earned income tax credit (EITC) and verifying employment reported on a tax return.

Generally, the IRS obtains employment and unemployment data less frequently than quarterly, and there are significant internal costs of preparing these data for use. Under various State laws, the IRS may negotiate for access to employment and unemployment data directly from State agencies that maintain these data.

Reasons for Change

Employment data are useful to the IRS in administering a wide range of tax provisions beyond the EITC, including verifying taxpayer claims and identifying levy sources. Currently, the IRS may obtain employment and unemployment data on a State-by-State basis, which is a costly and time-consuming process. NDNH data are timely, uniformly compiled, and electronically accessible. Access to the NDNH would increase the productivity of the IRS by reducing the amount of IRS resources dedicated to obtaining and processing data without reducing the current levels of taxpayer privacy.

Proposal

The proposal would amend the Social Security Act to expand IRS access to NDNH 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. Data obtained by the IRS from the NDNH would be protected by existing taxpayer privacy law, including civil and criminal sanctions.

The proposal would be effective upon enactment.

MAKE REPEATED WILLFUL FAILURE TO FILE A TAX RETURN A FELONY

Current Law

Current law provides that willful failure to file a tax return is a misdemeanor punishable by a term of imprisonment for not more than one year, a fine of not more than $25,000 ($100,000 in the case of a corporation), or both. A taxpayer who fails to file returns for multiple years commits a separate misdemeanor offense for each year.

Reasons for Change

Increased criminal penalties would help to deter multiple willful failures to file tax returns.

Proposal

The proposal would provide that any person who willfully fails to file tax returns in any three years within any five consecutive year period, if the aggregated tax liability for such period is at least $50,000, would be subject to a new aggravated failure to file criminal penalty. The proposal would classify such failure as a felony and, upon conviction, impose a fine of not more than $250,000 ($500,000 in the case of a corporation) or imprisonment for not more than five years, or both.

The proposal would be effective for returns required to be filed after December 31, 2012.

FACILITATE TAX COMPLIANCE WITH LOCAL JURISDICTIONS

Current Law

Although Federal tax returns and return information (FTI) generally are confidential, the Internal Revenue Service (IRS) and Treasury Department may share FTI with States as well as certain local government entities that are treated as States for this purpose. Generally, the purpose of information sharing is to facilitate tax administration. Where sharing of FTI is authorized, reciprocal provisions generally authorize disclosure of information to the IRS by State and local governments. State and local governments that receive FTI must safeguard it according to prescribed protocols that require secure storage, restricted access, reports to IRS, and shredding or other proper disposal. Criminal and civil sanctions apply to unauthorized disclosure or inspection of FTI. Indian Tribal Governments (ITGs) are treated as States by the tax law for several purposes, such as certain charitable contributions, excise tax credits, and local tax deductions, but not for purposes of information sharing.

Reasons for Change

IRS and Treasury compliance activity, especially with respect to alcohol, tobacco, and fuel excise taxes, may necessitate information sharing with ITGs. For example, the IRS may wish to confirm if a fuel supplier's claim to have delivered particular amounts to adjacent jurisdictions is consistent with that reported to the IRS. If not, the IRS in conjunction with the ITG, which would have responsibility for administering taxes imposed by the ITG, can take steps to ensure compliance with both Federal and ITG tax laws. Where the local government is treated as a State for information sharing purposes, IRS, Treasury, and local officials can support each other's efforts. Where the local government is not so treated, there is an impediment to compliance activity.

Proposal

For purposes of information sharing, the proposal would treat as States those ITGs that impose alcohol, tobacco, or fuel excise or income or wage taxes, to the extent necessary for ITG tax administration. An ITG that receives FTI would be required to safeguard it according to prescribed protocols. The criminal and civil sanctions would apply.

The proposal would be effective for disclosures made after enactment.

EXTEND STATUTE OF LIMITATIONS WHERE STATE ADJUSTMENT AFFECTS FEDERAL TAX LIABILITY

Current Law

In general, additional Federal tax liabilities in the form of tax, interest, penalties, and additions to tax must be assessed by the Internal Revenue Service (IRS) within three years after the date a return is filed. If an assessment is not made within the required time period, the additional liabilities generally cannot be assessed or collected at any future time. In general, the statute of limitations with respect to claims for refund expires three years from the time the return was filed or two years from the time the tax was paid, whichever is later. The Code contains exceptions to the general statute of limitations.

State and local authorities employ a variety of statutes of limitations for State and local tax assessments. Pursuant to agreement, the IRS and State and local revenue agencies exchange reports of adjustments made through examination so that corresponding adjustments can be made by each taxing authority. In addition, States provide the IRS with reports of potential discrepancies between State returns and Federal returns.

Reasons for Change

The general statute of limitations serves as a barrier to the effective use by the IRS of State and local tax adjustment reports when the reports are provided by the State or local revenue agency to the IRS with little time remaining for assessments to be made at the Federal level. Under the current statute of limitations framework, taxpayers may seek to extend the State statute of limitations or postpone agreement to State proposed adjustments until such time as the Federal statute of limitations expires in order to preclude assessment at the Federal level. In addition, it is not always the case that a taxpayer that files an amended State or local return reporting additional liabilities at the State or local level that also affect Federal tax liability will file an amended return at the Federal level.

Proposal

The proposal would create an additional exception to the general three-year statute of limitations for assessment of Federal tax liability resulting from adjustments to State or local tax liability. The statute of limitations would be extended to the greater of: (1) one year from the date the taxpayer first files an amended tax 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 in place between the IRS and a State or local revenue agency. The statute of limitations would be extended only with respect to the increase in Federal tax attributable to the State or local tax adjustment. The statute of limitations would not be further extended if the taxpayer files additional amended returns for the same tax periods as the initial amended return or if the IRS receives additional information from the State or local revenue agency under an information sharing agreement. The statute of limitations on claims for refund would be extended correspondingly so that any overall increase in tax assessed by the IRS as a result of the State or local examination report would take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

The proposal would be effective for returns required to be filed after December 31, 2012.

IMPROVE INVESTIGATIVE DISCLOSURE STATUTE

Current Law

Generally, tax return information is confidential, unless a specific exception in the Code applies. In the case of tax administration, the Code permits Treasury and Internal Revenue Service (IRS) officers and employees to disclose return information to the extent necessary to obtain information that is not otherwise reasonably available, in the course of an audit or investigation, as prescribed by regulation. Thus, for example, a revenue agent may identify himself or herself as affiliated with the IRS, and may disclose the nature and subject of an investigation, as necessary to elicit information from a witness in connection with that investigation. Criminal and civil sanctions apply to unauthorized disclosures of return information.

Reasons for Change

Treasury Regulations effective since 2003 state that the term “necessary” in this context does not mean essential or indispensable, but rather appropriate and helpful in obtaining the information sought. In other contexts, a “necessary” disclosure is one without which performance cannot be accomplished reasonably without the disclosure. Determining if an investigative disclosure is “necessary” is inherently factual, leading to inconsistent opinions by the courts. Eliminating this uncertainty from the statute would facilitate investigations by IRS officers and employees, while setting forth clear guidance for taxpayers, thus enhancing compliance with the tax Code.

Proposal

The proposal would clarify the taxpayer privacy law by stating that the law does not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

The proposal would be effective for disclosures made after enactment.

REQUIRE TAXPAYERS WHO PREPARE THEIR RETURNS ELECTRONICALLY BUT FILE THEIR RETURNS ON PAPER TO PRINT THEIR RETURNS WITH A 2-D BAR CODE

Current Law

Taxpayers can prepare their tax returns electronically (either by utilizing a tax return preparer or using tax return software at home) and, instead of filing their returns electronically, may print out a paper copy and file the return on paper by mailing it to the Internal Revenue Service (IRS).

Reasons for Change

Electronically filed tax returns are processed more efficiently and more accurately than paper tax returns. When tax returns are filed on paper—even if that paper return was prepared electronically—the IRS is unable to scan the return and the information contained on the return must be manually entered into the IRS's systems.

New scanning technology would allow the IRS to scan paper tax returns and capture all data shown on the return, if the paper return contains a 2-D bar code that would allow conversion of the paper return into an electronic format. This would reduce transcription errors and the amount of training, recruiting, and staffing that the IRS requires to process paper tax returns. In addition, the IRS would have greater access to more accurate tax data, thereby improving case selection, assisting in the detection of fraudulent tax returns, and allowing more comprehensive analysis of taxpayer behavior.

Proposal

The proposal would require all taxpayers who prepare their tax returns electronically but print their returns and file them on paper to print their returns with a 2-D bar code that can be scanned by the IRS to convert the paper return into an electronic format.

The proposal would be effective for tax returns filed after December 31, 2012.

ALLOW THE INTERNAL REVENUE SERVICE (IRS) TO ABSORB CREDIT AND DEBIT CARD PROCESSING FEES FOR CERTAIN TAX PAYMENTS

Current Law

Section 6311 permits the IRS to receive payment of taxes by any commercially acceptable means that the Secretary deems appropriate. Taxpayers may make credit or debit card payments by phone through IRS-designated third-party service providers, but these providers charge the taxpayer a convenience fee over and above the taxes due. Taxpayers cannot make a credit or debit card payment by phone directly to IRS collection representatives. Under current law, if the IRS were to accept credit or debit card payments directly from taxpayers, the IRS is prohibited from absorbing credit or debit card processing fees.

Reasons for Change

When taxpayers agree to make additional payments during telephone consultations with IRS agents, it is inefficient for both taxpayers and the IRS to require taxpayers to contact a third party service provider to make credit and debit card payments. Both the requirement for a separate call to a service provider and the additional processing fee for such payments may also discourage payment of outstanding liabilities, resulting in greater collection costs for the IRS, fewer IRS resources available to contact additional taxpayers, and lower tax collections. Allowing IRS to accept credit and debit card payments directly and allowing the IRS to absorb the credit and debit card processing fees would increase efficiency and the number of collection cases worked. Permitting the IRS to absorb the processing fee would increase payment options available to taxpayers.

Proposal

The proposal would amend Section 6311(d) to allow, but not require, the IRS to accept credit or debit card payments directly from taxpayers and to absorb the credit and debit card processing fees for delinquent tax payments, without charging a separate processing fee to the taxpayer.

The proposal would be effective for payments made after the date of enactment.

IMPROVE AND MAKE PERMANENT THE PROVISION AUTHORIZING THE INTERNAL REVENUE SERVICE (IRS) TO DISCLOSE CERTAIN RETURN INFORMATION TO CERTAIN PRISON OFFICIALS

Current Law

Section 6103(k)(10) authorized the IRS to disclose to the head of the Federal Bureau of Prisons (BOP) and the head of any State agency charged with the responsibility for administering prisons any return information with respect to individuals incarcerated in Federal or State prison whom the IRS determined may have filed or facilitated the filing of a false return. This authorization expired on December 31, 2011.

Reasons for Change

The IRS has become aware that some incarcerated individuals are filing, or participating in schemes to file, false tax returns. The prior disclosure provision permitted the IRS to share return information about these individuals with the head of the BOP and the head of any State agency in order to allow prison officials to take disciplinary action against these individuals.

The IRS has entered into Memoranda of Understanding (MOUs) with the BOP and several State agencies charged with the responsibility for administering prisons to provide such return information. Before the prior disclosure provision expired, the IRS had shared some return information with the BOP and State agencies.

Sharing this information allowed the IRS, the BOP, and State agencies to identify areas where the prior disclosure provision could be improved to increase efficiency and effectiveness. For example, the BOP and State agencies have indicated that it would be more effective to receive a copy of the tax return itself and not merely the return information because the tax return—showing the prisoner's signature—is more likely to satisfy the required burden of proof for the BOP and State agencies to prove that the prisoner filed a fraudulent return. Similarly, disclosing the tax returns and return information directly to the officers and employees of the BOP and State agencies responsible for disciplining prisoners would reduce administrative burdens and increase efficiency. In addition, permitting the redisclosure of return information to contractors that operate prisons would ensure that all prisoners are treated equally, rather than conferring an unintended benefit on prisoners who are incarcerated in prisons operated by contractors.

Proposal

The proposal would reinstate the provision authorizing the IRS to disclose return information with respect to individuals incarcerated in Federal or State prisons whom the IRS determines may have filed or facilitated the filing of a false return. The proposal also includes the following changes to the prior provision: (1) make the authorization for disclosure permanent, (2) authorize the disclosure of actual returns (and not just return information), (3) allow disclosure directly to officers and employees of the Federal or State prison agency, (4) allow redisclosure of return information to contractors that operate prisons, and (5) clarify the authority for the redisclosure to, and use of return information by, legal representatives to defend against inmate claims. These changes to the prior provision will increase the provision's efficiency and effectiveness.

The proposal would become effective upon enactment.

EXTEND INTERNAL REVENUE SERVICE (IRS) MATH ERROR AUTHORITY IN CERTAIN CIRCUMSTANCES

Current Law

Section 6213 imposes certain procedural requirements on the IRS when it determines that a taxpayer has a deficiency. These general deficiency procedures include referring tax returns that the IRS believes contain errors for an audit of the return. If an examiner determines that there is a deficiency, a statutory notice of deficiency must be issued and the taxpayer is provided an opportunity to challenge the proposed deficiency in Tax Court before the deficiency is assessed. These procedures are time consuming and expend significant IRS resources.

Section 6213(b), however, contains an exception to the general deficiency procedures by granting the IRS authority to correct certain mathematical or clerical errors made on tax returns (such authority is generally referred to as "math error authority") to reflect the taxpayer's correct tax liability. "Mathematical and clerical error" is defined in section 6213(g)(2) and currently includes, among other things: (1) errors in addition, subtraction, multiplication, or division shown on any return; (2) an entry on a return of an item that is inconsistent with another entry of the same or another item on the return; (3) an omission of a correct taxpayer identification number (TIN) required to be included on a tax return for the earned income tax credit (EITC); and (4) an omission of a correct TIN required to be included on a return for the higher education tax credits.

Reasons for Change

Using math error authority allows the IRS to adjust tax returns in cases where the IRS has reliable information that a taxpayer has an error on his or her return. Using math error authority in these circumstances is an efficient use of IRS resources.

Current law does not permit the IRS to use math error authority to assess additional amounts if (1) a taxpayer exceeds a lifetime limit on (a) the total amount of a credit or deduction that may be claimed or (b) the total number of years that a credit or deduction may be claimed; or (2) the taxpayer claims the EITC when the taxpayer is banned from doing so for a period of years because it was determined that the taxpayer's previous EITC claim was due to fraud or reckless or intentional disregard of the rules and regulations.

Adding these two items to the list of circumstances where the IRS is permitted to use math error authority would increase the efficiency of tax administration by permitting the IRS to disallow clearly erroneous claims and reducing the need for audit, and they would promote fairness by limiting such claims to those taxpayers who are, in fact, entitled to them.

Proposal

The proposal would add two items to the list of circumstances where the IRS has math error authority: (1) a taxpayer claimed a deduction or credit in excess of a lifetime limit, or (2) a taxpayer claimed the EITC during a period of disallowance under section 32(k).

The proposal would be effective for taxable years beginning after December 31, 2012.

IMPOSE A PENALTY ON FAILURE TO COMPLY WITH ELECTRONIC FILING REQUIREMENTS

Current Law

Certain corporations and tax-exempt organizations (including certain charitable trusts and private foundations) are required to file their returns electronically. Generally, filing on paper instead of electronically is treated as a failure to file if electronic filing is required. Additions to tax are imposed for the failure to file tax returns that report a liability. For failure to file a corporate return, the addition to tax is 5 percent of the amount required to be shown as tax due on the return for the first month of failure, and an additional 5 percent for each month or part of a month thereafter, up to a maximum of 25 percent.

For failure to file a tax-exempt organization return, the addition to tax is $20 a day for each day the failure continues. The maximum amount per return is $10,000 or 5 percent of the organization's gross receipts for the year, whichever is less. Organizations with annual gross receipts exceeding $1 million, however, are subject to an addition to tax of $100 per day, with a maximum of $50,000.

Reasons for Change

Although there are additions to tax for the failure to file returns, there is no specific penalty for a failure to comply with a requirement to file electronically. Because the addition to tax for failure to file a corporate return is based on an underpayment of tax, no addition is imposed if the corporation is in a refund, credit, or loss status. Thus, the existing addition to tax may not provide an adequate incentive for certain corporations to file electronically. Generally, electronic filing increases efficiency of tax administration because the provision of tax return information in an electronic form enables the Internal Revenue Service to focus audit activities where they can have the greatest impact. This also assists taxpayers where the need for audit is reduced.

Proposal

The proposal would establish an assessable penalty for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The amount of the penalty would be $25,000 for a corporation or $5,000 for a tax-exempt organization. For failure to file in any format, the existing penalty would remain, and the proposed penalty would not apply.

The proposal would be effective for returns required to be electronically filed after December 31, 2012.

SIMPLIFY THE TAX SYSTEM

SIMPLIFY THE RULES FOR CLAIMING THE EARNED INCOME TAX CREDIT (EITC) FOR WORKERS WITHOUT QUALIFYING CHILDREN

Current Law

Low and moderate-income workers may be eligible for a refundable EITC. Eligibility for the EITC is based on the number of qualifying children in the worker's household, adjusted gross income (AGI), earned income, investment income, filing status, age, and immigration and work status in the United States.

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a maximum range (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit). The EITC for workers without qualifying children is much smaller and phases out at a lower income level than does the EITC for workers with qualifying children.

In general, taxpayers with low wages who do not have any qualifying children may be eligible to claim the small EITC for workers without qualifying children. However, if the taxpayer resides with a qualifying child whom the taxpayer does not claim (perhaps because that child is claimed by another individual within the household), the taxpayer is not eligible for any EITC.

Reasons for Change

Prohibiting a taxpayer who resides with a qualifying child whom the taxpayer does not claim from claiming the EITC for workers without qualifying children is confusing to taxpayers, and difficult for the IRS to enforce. The prohibition is also inequitable and weakens the work incentives of the credit.

Proposal

The proposal would allow otherwise eligible taxpayers residing with qualifying children whom they do not claim to claim the EITC for workers without qualifying children.

The proposal would be effective for taxable years beginning after December 31, 2012.

ELIMINATE MINIMUM REQUIRED DISTRIBUTION (MRD) RULES FOR INDIVIDUAL RETIREMENT ACCOUNT OR ANNUITY (IRA) PLAN BALANCES OF $75,000 OR LESS

Current Law

The MRD rules generally require participants in tax-favored retirement plans, including qualified plans under section 401(a), section 401(k) cash or deferred arrangements, section 403(a) annuity plans, section 403(b) programs for public schools and charitable organizations, eligible deferred compensation plans under section 457(b), Simplified Employee Pensions (SEPs), and SIMPLE plans, as well as owners of IRAs, to begin receiving distributions shortly after attaining age 70½. The rules also generally require that these retirement assets be distributed to the plan participant or IRA owner (or their spouses or other beneficiaries), in accordance with regulations, over their life or a period based on their life expectancy (or the joint lives or life expectancies of the participant/owner and beneficiary).[13] Roth IRAs are not subject to the MRD rules during the life of the Roth IRA holder, but the MRD rules do apply to Roth IRAs after the death of the holder.

If a participant or account owner fails to take, in part or in full, the minimum required distribution for a year by the applicable deadline, the amount not withdrawn is subject to a 50-percent excise tax.

Reasons for Change

The MRD rules are designed largely to prevent taxpayers from deferring taxation of amounts that were accorded tax-favored treatment to provide financial security during retirement and instead leaving them to accumulate in tax-exempt arrangements for the benefit of their heirs. Therefore, in the case of taxpayers who have accumulated substantial tax-favored retirement assets, the MRD rules help ensure that tax-favored retirement benefits are in fact used for retirement. Under current law, however, millions of senior citizens with only modest tax-favored retirement benefits to fall back on during retirement also must calculate the annual amount of their minimum required distributions, even though they are highly unlikely to try to defer withdrawal and taxation of these benefits for estate planning purposes. In addition to simplifying tax compliance for these individuals, the proposal permits them greater flexibility in determining when and how rapidly to draw down their limited retirement savings.

Proposal

The proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA[14] and tax-favored retirement plan accumulations does not exceed $75,000

[13] Participants in tax-favored retirement plans (excluding IRAs) other than owners of at least 5 percent of the business sponsoring the retirement plan may wait to begin distributions until the year of retirement, if that year is later than the year in which the participant reaches age 70 ½ .

[14] While Roth IRAs are exempt from the pre-death MRD rules, amounts held in Roth IRAs would be taken into account in determining whether an individual's aggregate retirement accumulations exceed the $75,000 threshold.

(indexed for inflation) on a measurement date. However, benefits under qualified defined benefit pension plans that have already begun to be paid in life annuity form (including any form of life annuity, such as a joint and survivor annuity, a single life annuity, or a life annuity with a term certain) would be excluded. The MRD requirements would phase in ratably for individuals with aggregate retirement benefits between $75,000 and $85,000. The initial measurement date for the dollar threshold would be the beginning of the calendar year in which the individual reaches age 70½ or, if earlier, in which the individual dies, with additional measurement dates only at the beginning of the calendar year immediately following any calendar year in which the individual's IRAs or plans receive contributions, rollovers, or transfers of amounts that were not previously taken into account.

The proposal would be effective for taxpayers attaining age 70½ on or after December 31, 2012.

ALLOW ALL INHERITED PLAN AND INDIVIDUAL RETIREMENT ACCOUNT OR ANNUITY (IRA) BALANCES TO BE ROLLED OVER WITHIN 60 DAYS

Current Law

Generally, assets can be moved from a tax-favored employer retirement plan or from an IRA into an IRA or into an eligible retirement plan without adverse tax consequences. This movement of assets can generally be accomplished through a direct rollover of a distribution, a 60-day rollover, or a direct trustee-to-trustee transfer that is not a distribution. However, not all of these methods are available with respect to assets of a plan or IRA account inherited by a non-spouse beneficiary.

In particular, when a participant in a tax-favored employer retirement plan dies before all assets in the plan have been distributed, a beneficiary who is a surviving spouse may roll over the assets, by direct rollover or 60-day rollover, into an IRA that is treated either as a spousal inherited IRA or as the surviving spouse's own IRA. A beneficiary who is not a surviving spouse, on the other hand, may roll over the assets into an IRA that is a non-spousal inherited IRA only by means of a direct rollover; a 60-day rollover is not available to a surviving non-spouse beneficiary.

Similarly, when the owner of an IRA dies before all assets in the IRA have been distributed, a surviving spouse beneficiary may elect to treat the assets as his or her own IRA or as a spousal inherited IRA. In addition, a surviving spouse beneficiary may roll over the assets into an IRA that is treated either as the surviving spouse's own IRA or as a spousal inherited IRA. A surviving non-spouse beneficiary, on the other hand, may treat the assets as a non-spousal inherited IRA, and may move the assets to another non-spousal inherited IRA only by means of a direct trustee-to-trustee transfer; rollovers from the deceased owner's IRA to another IRA are not available for a surviving non-spouse beneficiary.

Reasons for Change

The rules that a surviving non-spouse beneficiary under a tax-favored employer retirement plan may roll over assets to an IRA only by means of a direct rollover and that a surviving non-spouse beneficiary under an IRA may move assets to a non-spousal inherited IRA only by means of a direct trustee-to-trustee transfer create traps for the unwary. These differences in rollover eligibility between surviving non-spouse beneficiaries and surviving spouse beneficiaries (and living participants) serve little purpose and generate confusion among plan and IRA administrators and beneficiaries. For example, IRA administrators often treat all transfers (whether or not an IRA account is a non-spousal inherited IRA) as rollovers, thereby causing confusion for individuals and the Internal Revenue Service. Similarly non-spouse beneficiaries may attempt to move assets to an inherited IRA by means of a 60-day rollover.

Proposal

The proposal would expand the options that are available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited plan or IRA assets to a non-spousal inherited IRA by allowing 60-day rollovers of such assets. This treatment would be available only if the beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA, so that the IRA provider can title the IRA accordingly.

The proposal would be effective for distributions made after December 31, 2012.

CLARIFY EXCEPTION TO RECAPTURE UNRECOGNIZED GAIN ON SALE OF STOCK TO AN EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

Current Law

Section 1042 allows a taxpayer to elect to defer the recognition of long-term capital gain on the sale of employer securities to an ESOP under certain circumstances and subject to certain conditions, including purchase of qualified replacement property within a specified period. The deferred gain is subject to recapture on disposition of the qualified replacement property unless an exception applies. One of the exceptions is for a disposition by gift.

Reasons for Change

Section 1041 generally provides that no gain or loss is recognized on a transfer of property between spouses, including former spouses if incident to divorce, treating such a transfer instead as a gift received by the transferee. However, section 1041 does not expressly address the treatment of the transferor, and section 1042 provides no express exception to the recapture rules for a nontaxable transfer of qualified replacement property to a spouse, including pursuant to a divorce, under section 1041. This has given rise to questions as to whether a transfer incident to a divorce is a disposition that triggers recapture under 1042.

Proposal

The proposal would amend the recapture rules of section 1042 to provide an exception for transfers under section 1041.

The proposal would be effective with respect to transfers made under section 1041 after December 31, 2012. No inference as to prior law is intended.

REPEAL NON-QUALIFIED PREFERRED STOCK (NQPS) DESIGNATION

Current Law

In 1997 Congress added a provision to section 351 that treats NQPS as taxable "boot" for certain purposes. In addition to its treatment as boot in corporate organizations, NQPS is also treated as boot in certain shareholder exchanges pursuant to a plan of corporate reorganization. NQPS is stock that (i) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (ii) has a dividend rate that varies with reference to an index, or, in certain circumstances, a put right, a call right, or a mandatory redemption feature. The addition of this provision reflected the belief that the receipt of certain types of preferred stock more appropriately represented taxable consideration because the investor/transferor obtained a more secure form of investment.

Reasons for Change

NQPS is treated like debt for certain limited purposes but is otherwise generally treated as stock. This hybrid nature of NQPS has transformed it into a staple of affirmative corporate tax planning: its issuance often occurs in loss-recognition planning, where NQPS is treated as debt-like boot, or to avoid the application of a provision that treats a related-party stock sale as a dividend. Thus, for the unwary, the designation and treatment of NQPS represents a proverbial trap that adds additional complexity to the tax code, while for the well-advised, the issuance of NQPS often arises in transactions that are inconsistent with the original purpose of the 1997 provision.

Proposal

The proposal would repeal the NQPS provision and other cross-referencing provisions of the Code that treat NQPS as boot.

The proposal would be effective for stock issued after December 31, 2012.

REPEAL PREFERENTIAL DIVIDEND RULE FOR PUBLICLY OFFERED REAL ESTATE INVESTMENT TRUSTS (REITS)

Current Law

REITs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a "preferential dividend." For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. Before last year, a similar rule had applied to all regulated investment companies (RICs). Section 307 of the Regulated Investment Company Modernization Act of 2010 (Pub. L. No. 111–325) repealed application of that rule for publicly offered RICs.

Reasons for Change

The original purpose of the preferential dividend rule in 1936 was to prevent tax avoidance by closely held personal holding companies. The inflexibility of the rule can produce harsh results for inadvertent deviations in the timing or amount of distributions to some shareholders. Because an attempt to compensate for a preference in one distribution produces a preference in a second offsetting distribution, it is almost impossible to undo the impact of a prior error.
As applied to publicly traded REITs and publicly offered REITs, the rule has ceased to serve a necessary function either in preventing tax avoidance or in ensuring fairness among shareholders. Today, for these shareholders, corporate and securities laws bar preferences and ensure fair treatment.

Proposal

The proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if—

- As of the record date of the distribution, the REIT was publicly traded; or

- As of the record date of the distribution—
    - The REIT was required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Act of 1934;
    - Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318); and
    - Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10–year period.

The Treasury Department would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders.

The proposal would apply to distributions that are made (without regard to section 858) in taxable years beginning after the date of enactment.

REFORM EXCISE TAX BASED ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS

Current Law

Private foundations that are exempt from federal income tax generally are subject to a 2-percent excise tax on their net investment income. The excise tax rate is reduced to 1 percent in any year in which the foundation's distributions for charitable purposes exceed the average level of the foundation's charitable distributions over the five preceding taxable years (with certain adjustments). Private foundations that are not exempt from federal income tax, including certain charitable trusts, must pay an excise tax equal to the excess (if any) of the sum of the excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. Under current law, private nonoperating foundations generally are required to make annual distributions for charitable purposes equal to 5 percent of the fair market value of the foundation's noncharitable use assets (with certain adjustments). The amount that a foundation is required to distribute annually for charitable purposes is reduced by the amount of the excise tax paid by the foundation.

Reasons for Change

The current "two-tier" structure of the excise tax on private foundation net investment income may discourage foundations from significantly increasing their charitable distributions in any particular year. An increase in a private foundation's distributions in one year will increase the foundation's five-year average percentage payout, making it more difficult for the foundation to qualify for the reduced 1-percent excise tax rate in subsequent years. Because amounts paid by foundations in excise tax generally reduce the funds available for distribution to charitable beneficiaries, eliminating the "two-tier" structure of this excise tax would ensure that a private foundation's grantees do not suffer adverse consequences if the foundation increases its grantmaking in a particular year to respond to charitable needs (for example, disaster relief). Such a change would also simplify both the calculation of the excise tax and charitable distribution planning for private foundations.

Proposal

This proposal would replace the two rates of tax on private foundations that are exempt from federal income tax with a single tax rate of 1.35 percent. The tax on private foundations not exempt from federal income tax would be equal to the excess (if any) of the sum of the 1.35-percent excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. The special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions would be repealed.

The proposal would be effective for taxable years beginning after the date of enactment.

REMOVE BONDING REQUIREMENTS FOR CERTAIN TAXPAYERS SUBJECT TO FEDERAL EXCISE TAXES ON DISTILLED SPIRITS, WINE AND BEER

Current Law

The Alcohol and Tobacco Tax and Trade Bureau (TTB) collects taxes on distilled spirits, wines, and beer under Chapter 51 of Title 26 of the United States Code. The method by which TTB collects these taxes is provided in 26 U.S.C. § 5061.

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA), was enacted into Public Law 109-59 on August 10, 2005. Section 11127, "Quarterly Excise Tax Filing for Small Alcohol Excise Taxpayers" of SAFETEA amended 26 U.S.C. § 5061(d)(4) so that importers and producers of distilled spirits, wine, and beer with a reasonably expected excise tax liability of $50,000 or less in a calendar year, who were liable for not more than $50,000 in such taxes in the preceding calendar year, could file returns and pay taxes within 14 days after the end of the calendar quarter.

The option for small beverage alcohol excise taxpayers ("small taxpayers") to file and pay taxes quarterly, rather than semi-monthly, currently only applies to withdrawals, removals, and entries (and articles brought into the United States from Puerto Rico) under bond.

Additionally, TTB has administratively allowed eligible wineries who paid excise taxes in an amount less than $1,000 during the previous calendar year to file taxes annually pursuant to the regulatory bond framework promulgated under the bond authority for wineries in 26 U.S.C. § 5354 and the tax return period filing authority under 26 U.S.C. § 5061.

Reasons for Change

For calendar year 2010, 89 percent (6,732 of 7,567) of beverage alcohol taxpayers (manufacturers, producers, and importers of distilled spirits, wine, and beer) had a tax liability of less than $50,000. Of these, 2,810 still filed semi-monthly, although they have the option to file quarterly.

Small taxpayers may choose to continue to file taxes semi-monthly because they would have to increase their deferral bond amounts if they were to file taxes quarterly. By eliminating the bond requirements for small taxpayers, quarterly filing would be less burdensome. This would also lessen the burden for TTB in processing the tax payments.

Distilled spirits and beer taxpayers who paid excise taxes in an amount less than $1,000 during the previous calendar year are not eligible to file taxes annually, as wineries are.

Proposal

The proposal would require any distilled spirits, wines, and beer taxpayer who reasonably expects to be liable for not more than $50,000 per year in alcohol excise taxes (and who was liable for not more than $50,000 in such taxes in the preceding calendar year) to file and pay such taxes quarterly, rather than semi-monthly. The proposal would also create an exemption from the bond requirement in the Internal Revenue Code of 1986 (IRC) for these small taxpayers. The proposal includes conforming changes to the other sections of the IRC describing bond requirements.

Additionally, the proposal would allow any distilled spirits, wine, or beer taxpayer with a reasonably expected alcohol excise tax liability of not more than $1,000 per year to file and pay such taxes annually rather than on a quarterly basis. The proposal will create parity among alcohol taxpayers by allowing eligible distilled spirits and beer taxpayers to file annually as well.

The proposal would be effective 90 days after the date of enactment.

Simplify Tax-Exempt Bonds

SIMPLIFY ARBITRAGE INVESTMENT RESTRICTIONS

Current Law

Section 103 provides generally that interest on debt obligations issued by State and local governments for governmental purposes is excludable from gross income. Section 148 imposes two types of complex arbitrage investment restrictions on investments of tax-exempt bond proceeds pending use for governmental purposes. These restrictions generally limit investment returns that exceed the yield or effective interest rate on the tax-exempt bonds. One type of restriction, called "yield restriction," limits investment returns in the first instance, and a second type, called "rebate," requires issuers to repay arbitrage investment earnings to the Federal Government at prescribed intervals. These restrictions developed in different ways over a long period of time, beginning with yield restriction in 1969 and continuing with the extension of the rebate requirement to all tax-exempt bonds in 1986. Various exceptions apply in different ways to these two types of arbitrage restrictions, including exceptions for prompt expenditures of bond proceeds, reasonable debt service reserve funds, small issuers, and other situations.

With respect to spending exceptions, a two-year construction spending exception to arbitrage rebate under section 148(f)(4)(C) applies to certain categories of tax-exempt bonds (including bonds for governmental entities and nonprofit entities, but excluding most private activity bonds). This two-year construction spending exception has semiannual spending targets, bifurcation rules to isolate construction expenditures, and elective penalties in lieu of rebate for failures to meet spending targets. Separately, a longstanding regulatory three-year spending exception to yield restriction is available for all tax-exempt bonds used for capital projects.

A small issuer exception to arbitrage rebate under section 148(f)(4)(D) applies to certain governmental small issuers with general taxing powers if they issue no more than $5 million in tax-exempt bonds in a particular year. The small issuer exception has been in effect since 1986 without change, except for an increase to $15 million for certain public school expenditures.

Reasons for Change

The arbitrage investment restrictions create unnecessary complexity and compliance burdens for State and local governments in several respects. In general, the two types of arbitrage restrictions (yield restriction and rebate) are duplicative and overlapping and they have the same tax policy objective to limit arbitrage profit incentives for excess issuance of tax-exempt bonds. While Treasury Regulations have integrated these restrictions partially, further statutory integration of the arbitrage restrictions could provide a simpler and more unified framework.

Moreover, the two-year construction spending exception to arbitrage rebate is extremely complex. This exception has restricted eligibility rules, unduly-short spending targets, and complex penalty elections that are rarely used. A streamlined spending exception could provide meaningful simplification and reduce compliance burdens. Limited arbitrage potential exists if issuers spend proceeds fairly promptly. By comparison, a recent uniform provision for qualified tax credit bonds under section 54A has a simplified three-year spending exception to arbitrage restrictions, along with a requirement to redeem bonds upon a failure to meet the spending rules.

An increase in the small issuer exception to arbitrage rebate would reduce compliance burdens for a large number of State and local governmental issuers while affecting a disproportionately smaller amount of tax-exempt bond dollar volume. For example, in 2008, issuers under a similar $10 million small issuer exception for bank-qualified tax-exempt bonds under section 265 issued about 39 percent of the total number of tax-exempt bond issues (4,195 out of 10,830 total bond issues), but only 3.9 percent of total dollar volume ($15.3 billion out of $389.6 billion).

Proposal

Unify Yield Restriction and Rebate Further. The proposal would unify yield restriction and rebate further by relying on arbitrage rebate as the principal type of arbitrage restriction on tax-exempt bonds. The proposal generally would repeal yield restriction, subject to limited exceptions under which yield restriction would continue to apply to investments of refunding escrows in advance refunding issues under section 149(d) and to other situations identified in regulations.

Broader Streamlined Three-year Spending Exception. The proposal would provide a broader streamlined three-year spending exception to arbitrage rebate for tax-exempt bonds that meet the following requirements:

(1) Eligible Tax-exempt Bonds. Eligible tax-exempt bonds would include all governmental bonds and private activity bonds, excluding only bonds used for advance refundings under section 149(d) or restricted working capital expenditures (as defined in regulations).

(2) Long-term Fixed Rate Bonds. The tax-exempt bonds would be required to have a fixed yield and a minimum weighted average maturity of at least five years.

(3) Spending Period. The issuer would be required to spend 95 percent of the bond within three years after the issue date.
(This 5 percent de minimis provision broadens the availability exception to cover many circumstances in which minor amounts of bond proceeds remain unspent for bona fide reasons.)

(4) Due Diligence. The issuer would be required to satisfy a due diligence standard in spending the bond proceeds.

Upon a failure to meet the spending requirements for this exception, the tax-exempt bond issue would revert to become subject to the arbitrage rebate requirement.

Increase Small Issuer Exception. The proposal would increase the small issuer exception to the arbitrage rebate requirement for tax-exempt bonds from $5 million to $10 million and index the size limit for inflation. The proposal also would remove the general taxing power constraint on small issuer eligibility.

The proposal would be effective for bonds issued after the date of enactment.

SIMPLIFY SINGLE-FAMILY HOUSING MORTGAGE BOND TARGETING REQUIREMENTS

Current Law

Section 143 allows use of tax-exempt qualified mortgage bonds to finance mortgage loans for owner-occupied single-family housing residences, subject to a number of targeting requirements, including, among others: a mortgagor income limitation (generally not more than 115 percent of applicable median family income, increased to 140 percent of such income for certain targeted areas, and also increased for certain high-cost areas); a purchase price limitation (generally not more than 90 percent of average area purchase prices, increased to 110 percent in targeted areas); refinancing limitation (generally only new mortgages for first-time homebuyers are eligible); and a targeted area availability requirement. In addition, the general restrictions on tax-exempt private activity bonds apply to these qualified mortgage bonds, including, among other restrictions, the State private activity bond volume cap under section 146.

Reasons for Change

The targeting requirements for qualified mortgage bonds are complex and excessive. The mortgagor income limit generally serves as an appropriate limit to target this lower cost borrowing subsidy to a needy class of low and moderate income beneficiaries. The mortgagor income limit typically is a more constraining factor than the purchase price limit. The restriction against refinancing limits the availability of this lower cost borrowing subsidy as a tool to address needs for affordable mortgage loan refinancing within a needy class of existing low and moderate income homeowners.

Proposal

The proposal would repeal the purchase price limitation under section 143(e) and the refinancing limitation under section 143(d) on tax-exempt qualified mortgage bonds.

This proposal would be effective for bonds issued after the date of enactment.

STREAMLINE PRIVATE BUSINESS LIMITS ON GOVERNMENTAL BONDS

Current Law

Section 141 treats tax-exempt bonds issued by State and local governments as governmental bonds if the issuer limits private business use and other private involvement sufficiently to avoid treatment as "private activity bonds." Bonds generally are classified as private activity bonds under a two-part test if more than 10 percent of the bond proceeds are both (1) used for private business use, and (2) payable or secured from property or payments derived from private business use.

Subsidiary restrictions further reduce the permitted thresholds of private involvement for governmental bonds in several ways. Section 141(b)(3) imposes a 5 percent unrelated or disproportionate private business use limit. Section 141(b)(4) imposes a $15 million cap on private business involvement for governmental output facilities (such as electric, gas, or other output generation, transmission, and distribution facilities, but excluding water facilities). Section 141(c) imposes a private loan limit equal to the lesser of 5 percent or $5 million of bond proceeds. Section 141(b)(5) requires a volume cap allocation for private business involvement that exceeds $15 million in larger transactions which otherwise comply with the general 10 percent private business limits.

Reasons for Change

The 10 percent private business limit generally represents a sufficient and workable threshold for governmental bond status. The volume cap requirement for private business involvement in excess of $15 million serves a control on private business involvement in larger transactions.

The particular subsidiary restriction which imposes a 5 percent limit on unrelated or disproportionate private business use introduces undue complexity, a narrow disqualification trigger, and attendant compliance burdens for State and local governments. The 5 percent unrelated or disproportionate private business use test requires difficult factual determinations regarding the relationship of private business use to governmental use in financed projects. This test is difficult to apply, particularly in governmental bond issues that finance multiple projects.

Proposal

The proposal would repeal the 5 percent unrelated or disproportionate private business use test under section 141(b)(3) to simplify the private business limits on tax-exempt governmental bonds.

This proposal would be effective for bonds issued after the date of enactment.

USER FEES

REFORM INLAND WATERWAYS FUNDING

Current Law

The Inland Waterways Trust Fund is authorized to pay 50 percent of the capital costs of the locks and dams and other features that make commercial transportation possible on the inland and intracoastal waterways. This trust fund is supported by a 20-cents-per-gallon excise tax on liquids used as fuel in a vessel in commercial waterway transportation. . The excise tax applies to commercial waterway transportation on a waterway listed in section 206 of the Inland Waterways Revenue Act of 1978, as amended. Commercial waterway transportation is defined as any use of a vessel on a listed waterway : (1) in the business of transporting property for compensation or hire; or (2) in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage). Exceptions are provided for deep-draft ocean-going vessels, passenger vessels, State and local governments, and certain ocean-going barges.

Reasons for Change

The fuel excise tax does not raise enough revenue to pay the full amount of the authorized expenditures from this trust fund. Moreover, the tax is not the most efficient method for financing expenditures on those waterways. Additional funding to supplement the amount collected from the excise tax can be provided through a more efficient user fee system.

Proposal

The Administration proposes to reform the laws governing the Inland Waterways Trust Fund, including establishing a new user fee. The proposal would increase the amount paid by commercial navigation users sufficiently to meet their share of the costs of activities financed from this trust fund. The Secretary of the Army would set the amount of the user fee each year to collect a total of $1.1 billion from the user fee over the first 10 years. Thereafter, the Secretary of the Army would adjust the user fee over time, so that the combined amount collected from the excise tax and the user fee covers the user-financed share of spending for inland waterways construction, replacement, expansion, and rehabilitation work.

OTHER INITIATIVES

ALLOW OFFSET OF FEDERAL INCOME TAX REFUNDS TO COLLECT DELINQUENT STATE INCOME TAXES FOR OUT-OF-STATE RESIDENTS

Current Law

Generally, the Treasury refunds a taxpayer who makes an overpayment (by withholding or otherwise) of Federal tax. The overpayment amount is reduced by (i.e., offset by) debts of the taxpayer for past-due child support, debts to Federal agencies, fraudulently obtained unemployment compensation, and past-due, legally enforceable State income tax obligations. In the latter case, a refund offset is permitted only if the delinquent taxpayer resides in the State seeking the offset.

Reasons for Change

Under current law, a delinquent taxpayer can escape offset of a Federal refund for a State tax liability as long as the taxpayer is not a resident of the State. Foreclosing this possibility would better leverage the capacity of the Federal tax refund offset program for the country as a whole.

Proposal

The proposal would permit offset of Federal refunds to collect State income tax, regardless of where the delinquent taxpayer resides.

The proposal would be effective on the date of enactment.

AUTHORIZE THE LIMITED SHARING OF BUSINESS TAX RETURN INFORMATION TO IMPROVE THE ACCURACY OF IMPORTANT MEASURES OF OUR ECONOMY

Current Law

Current law authorizes the Internal Revenue Service (IRS) to disclose certain federal tax information (FTI) for governmental statistical use. Business FTI may be disclosed to officers and employees of the Census Bureau for all businesses. Similarly, business FTI may be disclosed to officers and employees of the Bureau of Economic Analysis (BEA), but only for corporate businesses. Specific items permitted to be disclosed are detailed in the associated Treasury Regulations. The Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI.

Reasons for Change

BEA's limited access to business FTI and BLS's lack of access to business FTI prevents BEA, BLS and Census from synchronizing their business lists. Synchronization of business lists would significantly improve the consistency and quality of sensitive economic statistics including productivity, payroll, employment, and average hourly earnings.

In addition, given the growth of non-corporate businesses, especially in the service sector, the current limitation on BEA's access to corporate FTI impedes the measurement of income and international transactions in the National Accounts. The accuracy and consistency of income data are important to the formulation of fiscal policies.

Further, the Census's Business Register is constructed using both FTI and non-tax business data derived from the Economic Census and current economic surveys. Because this non-tax business data is inextricably co-mingled with FTI, it is not possible for Census to share data with BEA and BLS in any meaningful way.

Proposal

This proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than $250,000 and of all partnerships. BEA contractors would not have access to FTI.

This proposal would also give officers and employees of BLS access to certain business (and tax-exempt entities) FTI including: taxpayer identification number; name(s) of the business; business address (mailing address and physical location); principal industry activity (including business description); number of employees and total business-level wages (including wages, tips, and other compensation, quarterly from Form 941 and annually from Forms 943 and 944); and sales revenue for employer businesses only. BLS would not have access to individual employee FTI.

In other words, the proposal would allow officers and employees of each of BLS, BEA, and Census to access the same FTI for businesses, and would permit BLS, BEA, and Census to share such FTI amongst themselves (subject to the restrictions described below).

For the purpose of synchronizing BLS and Census business lists, the proposal would permit employees of state agencies to receive from BLS the following FTI identity items: taxpayer identification number, business name(s), business address(es), and principal industry activity (including business description). No BLS contractor or State agency contractor would have access to FTI.

The proposal would require any FTI to which BEA and BLS would have access, either directly from IRS, from Census, or from each other, to be used for statistical purposes consistently with the Confidential Information Protection and Statistical Efficiency Act (CIPSEA). The three statistical agencies and state agencies would be subject to taxpayer privacy law, safeguards, and penalties. They would also be subject to CIPSEA confidentiality safeguard procedures, requirements, and penalties. Conforming amendments to applicable statutes would be made as necessary to apply the taxpayer privacy law, including safeguards and penalties to BLS as well as Census and BEA. BLS would be required to monitor compliance by state agencies with the prescribed safeguard protocols.

The proposal would be effective upon enactment.

ELIMINATE CERTAIN REVIEWS CONDUCTED BY THE U.S. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION (TIGTA).

Current Law

Section 7803(d) requires the TIGTA to conduct reviews of certain administrative and civil actions and reviews of Internal Revenue Service (IRS) compliance with respect to certain requirements in order to comply with TIGTA's reporting requirements.

Reasons for Change

The statutory reviews that are proposed to be eliminated are of relatively low value and yield little in the way of performance measures. In order to make more efficient use of TIGTA's resources, TIGTA would prefer to redirect the resources applied to conduct these reviews to conducting high-risk audits.

Proposal

As requested by TIGTA, the proposal would eliminate TIGTA's obligation to report information regarding any administrative or civil actions related to Fair Tax Collection Practices violations in one of TIGTA's Semiannual Reports, review and certify annually that the IRS is complying with the requirements of section 6103(e)(8) regarding information on joint filers, and annually report on the IRS's compliance with sections 7521(b)(2) and (c) requiring IRS employees to stop a taxpayer interview whenever a taxpayer requests to consult with a representative and to obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if the representative has unreasonably delayed the completion of an examination or investigation.

The proposal would revise the annual reporting requirement for all remaining provisions in the IRS Restructuring and Reform Act of 1998 to a biennial reporting requirement.

The proposal would be effective after December 31, 2012.

MODIFY INDEXING TO PREVENT DEFLATIONARY ADJUSTMENTS

Current Law

Many parameters of the tax system – including the size of personal exemptions and standard deductions, the width of income tax rate brackets, the amount of certain other deductions and credits, and the maximum amount of various saving and retirement deductions – may be adjusted annually for the effects of inflation. The adjustments are based on annual changes in the level of the Consumer Price Index (CPI-U). Depending on the particular tax parameter, the adjustment may be based on CPI-U for a particular month, its average for a calendar quarter, or its average for a 12-month period (with various ending dates). The adjusted values are rounded differently, as specified in the Internal Revenue Code.

When inflation adjustment of tax parameters was enacted, it was generally contemplated that indexing would result in upward adjustments to reflect inflation. If price levels decline for the year, the inflation adjustment provisions for most adjusted tax parameters permit the tax parameters to become smaller, so long as they do not decline to less than their base period values specified in the Code. However, the statutory provisions for the indexing of those tax parameters adjusted pursuant to section 415(d) (generally relating to benefits and contributions under qualified plans) are held at their previous year's level if the relevant price index declines. In subsequent years, they increase only to the extent that the relevant price index exceeds its highest preceding relevant level.

Reasons for Change

Between 2008 and 2009, for the first time since inflation adjustments were enacted, the annual index values used for two of the indexing methods declined for the relevant annual period. The index level relevant for section 415(d) adjustments fell, but by statute those parameters remain at their 2009 levels for 2010. (They did not increase for 2011.) Also, the maximum size of a cash method debt instrument, as adjusted under section 1274A(d)(2) decreased for 2010. Other tax parameters did not decrease, since the price index relevant for their adjustments did not decline between 2008 and 2009.

The 2008 to 2009 price index changes demonstrate that a year-to-year decrease is possible. Preventing tax parameters from falling if the underlying price levels fall would make the tax system a more effective automatic economic stabilizer than it is under current law. Holding tax parameters constant would also prevent reductions in certain tax benefits for saving and retirement which should not be affected by short-term price level reductions.

Proposal

The proposal would modify inflation adjustment provisions so as to prevent tax parameters from declining from the previous year's levels if the underlying price index falls. Future inflation-related increases would be based on the highest previous level of the price index relevant for adjusting the particular tax parameter.

The proposal would be effective beginning on the date of enactment.

PROGRAM INTEGRITY INITIATIVES

INCREASE LEVY AUTHORITY FOR PAYMENTS TO MEDICARE PROVIDERS WITH DELINQUENT TAX DEBT

Current Law

Under the Medicare Improvement for Patients and Providers Act of 2008, the Treasury Department is authorized to continuously levy up to 15 percent of a payment to a Medicare provider in order to collect delinquent tax debt. Through the Federal Payment Levy Program, Treasury deducts (levies) a portion of a Government payment to an individual or business in order to collect unpaid taxes.

Reasons for Change

Certain Medicare providers fail to comply with their Federal income tax and/or employment tax obligations. Expanding to 100 percent the amount of Federal payments that can be levied for such providers will help recover a greater amount of delinquent taxes and will promote these providers' compliance with their Federal tax obligations.

Proposal

The proposal would allow Treasury to levy up to 100 percent of a payment to a Medicare provider to collect unpaid taxes.

The proposal would be effective for payments made after the date of enactment.

IMPLEMENT A PROGRAM INTEGRITY STATUTORY CAP ADJUSTMENT FOR THE INTERNAL REVENUE SERVICE (IRS)

Current Law

Previous Administrations and Congresses have used a budget mechanism called a program integrity cap adjustment to increase congressional allocations for annual budget appropriations. Under the mechanism, funding above the spending ceiling that is specified in the annual congressional appropriations process is granted for specified "program integrity" purposes. "Program integrity" broadly refers to maintaining the effectiveness of a specific government program. In the past, Congress has appropriated additional funding to the IRS through allocation adjustments for certain enforcement and compliance activities that generate positive net revenue.

Reasons for Change

The IRS currently collects about $55 billion in enforcement revenue each year through various enforcement and compliance activities, funded partially through a cap adjustment. These resources have been critical to maintaining the IRS enforcement and compliance functions, allowing the IRS to initiate new programs that generate high returns on investment, and encouraging taxpayers to comply with the tax laws. Additional funding for IRS enforcement and compliance programs will yield increases in enforcement revenue through activities with high returns and will help the IRS further expand and improve its effectiveness and efficiency as a tax administrator.

Proposal

The Administration proposes a multi-year program integrity cap adjustment for IRS tax enforcement, compliance, and related activities through an amendment to the Balanced Budget and Emergency Deficit Control Act of 1985 (BBEDCA), as amended by the Budget Control Act of 2011 (Public Law 112-25). The proposed cap adjustment for fiscal year 2013 will fund about $350 million in new revenue-producing initiatives above current levels of enforcement and compliance activity. These resources will help the IRS continue to target international tax compliance and implement information reporting authorities, among other activities. Beyond 2013, the Administration proposes to provide a further increase of about $350 million in additional new revenue-generating initiatives each fiscal year from 2014 through 2017 and to fund all of the new initiatives and inflationary costs via cap adjustments through FY 2021 and sustain this support in FY 2022. The total cost of supporting new initiatives above the funding needed to maintain current levels of enforcement and compliance activity would be approximately $17 billion once sustained through FY 2022.

ADJUSTMENTS TO THE BUDGET ENFORCEMENT ACT BASELINE

An important step in addressing the Nation's fiscal problems is to be upfront about them and to establish a baseline that provides a realistic measure of the deficit outlook before new policies are enacted. This Budget does so by adjusting the BEA baseline to reflect the true cost of extending major tax policies that are scheduled to expire but that are likely to be extended. The BEA baseline, which is commonly used in budgeting and is defined in statute, reflects, with some exceptions, the projected receipts level under current law.

However, current law includes a number of scheduled tax changes that are unlikely to occur and that prevent it from serving as a realistic benchmark for judging the effect of new legislation. These tax changes include expiration of most of the income tax reductions enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Job Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA), and extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA). They also include reversion of the estate, gift, and generation-skipping transfer (GST) taxes to pre-2001 parameters, and expiration of relief from the Alternative Minimum Tax (AMT).

This Budget uses an adjusted baseline that is intended to be more realistic. This baseline does not reflect the President's policy proposals, but is rather a realistic and fair benchmark from which to measure the effects of those policies. This baseline permanently continues the 2001 and 2003 tax cuts (as modified by subsequent legislation) for all taxpayers. The Administration's adjusted baseline also permanently continues estate, gift, and GST taxes at 2012 parameters and reflects permanent extension of relief from the AMT

Extend estate, gift, and GST taxes at 2012 parameters.—The Administration's adjusted baseline projection reflects permanent extension of the estate, gift, and GST tax parameters and provisions in effect for calendar year 2012, effective for decedents dying after December 31, 2012. Under those parameters, the estates and generation-skipping transfers of a decedent dying after December 31, 2012, are taxed at a maximum tax rate of 35 percent and are provided a life-time exclusion of $5 million (indexed for inflation from 2010 and after 2011). Gifts made after December 31, 2012, are taxed at a maximum tax rate of 35 percent and provided a life-time exclusion of $5 million. In addition, the portability of unused estate and gift exclusion amounts between spouses is permanently extended to apply to decedents dying after December 31, 2012.

Extend and index for inflation the 2011 parameters of the AMT as enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010—The Administration's adjusted baseline projection reflects permanent extension and annual indexation of: (1) the AMT exemption amounts in effect for taxable year 2011 ($48,450 for single taxpayers, $74,450 for married taxpayers filing a joint return and surviving spouses, and $37,225 for married taxpayers filing a separate return and for estates and trusts); (2) the income thresholds for the 28-percent AMT rate ($87,500 for married taxpayers filing a separate return and $175,000 for all other taxpayers); and (3) the income thresholds for the phaseout of the exemption amounts ($150,000 for married taxpayers filing a joint return and surviving spouses,

$112,500 for single taxpayers, and $75,000 for married taxpayers filing a separate return). The adjusted baseline projection also extends AMT relief for nonrefundable personal tax credits.

Extend EGTRRA and JGTRRA tax cuts – most of the tax reductions enacted in 2001 and 2003 were extended in 2010 and are set to expire on December 31, 2012. The Administration's baseline includes the cost of permanently extending:

- The 10-percent income tax bracket and the reduction of the 28, 31, 36 and 39.6-percent tax rates to 25, 28, 33 and 35 percent as provided under section 101(a) of EGTRRA.

- The child tax credit as provided under section 201 of EGTRRA and amended by the American Recovery and Reinvestment Act of 2009 (ARRA); that is, a credit of $1,000 per child, allowed against regular tax and the AMT, and refundable up to an amount equal to 15 percent of earned income in excess of $3,000 (not indexed).

- Tax benefits for married couples as provided for under title III of EGTRRA and amended by ARRA; that is, the increase in the standard deduction for joint filers to equal twice that of single taxpayers, the expansion of the 15-percent tax bracket for joint filers to twice the width of that for single taxpayers, and the $5,000 increase in the starting point of the earned income tax credit (EITC) phase-out range for joint filers (indexed beginning in 2010). Title III of EGTRRA and the baseline also include several modifications to simplify and improve compliance with the EITC.

- The expanded adoption tax credit as provided for under section 202 of EGTRRA; that is, a maximum credit of $10,000 (indexed for inflation after 2002) for adoptions of children with special-needs (without regard to expenses) and expenses related to other adoptions, allowed against regular tax and the AMT, phased out beginning at modified adjusted gross income of $150,000 (indexed after 2002). (The similar exclusion of employer-provided adoption assistance is also expanded.)

- The dependent care tax credit as provided for under section 204 of EGTRRA; that is, the maximum credit is $1,050 for one qualifying individual and $2,100 for two qualifying individuals.

- The employer-provided child care tax credit as provided for under section 205 of EGTRRA.

- The education tax benefits as provided for under title IV of EGTRRA. These benefits include an increase in the phase-out range to $190,000-$220,000 for married taxpayers filing jointly and an increase in the contribution limit to $2,000 for educations IRAs; an exclusion of up to $5,250 in employer provided education assistance; an increase in the phase-out range and elimination of the 60-month limit on the deductibility of student loan interest payments; and an exclusion from income of awards received under certain health professional programs; and, tax benefits for certain bonds to finance educational facilities and activities.

- The reduction in tax rates on capital gains from 10 and 20 percent to 0 and 15 percent, and the taxation of dividends at capital gains rather than ordinary rates, as provided for under sections 301 and 302 of JGTRRA.

- The elimination of the phase-out of personal exemptions and the elimination of the limitation on itemized deductions (Pease), as provided for under sections 102 and 103 of EGTRRA.

- The increased limits on expensing small business assets under section 179(b) of the Internal Revenue Code as provided for under section 202 of JGTRRA; that is, businesses would be able to expense up to $125,000 of investment, phased out dollar for dollar after investment reaches $500,000 (dollar levels indexed for inflation from 2006).

TABLES OF REVENUE ESTIMATES

Revenue estimates begin on the next page.