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TO: Clients and Friends

FROM: The Ruchelman Law Firm

RE: New Treasury Report on the Obama Administration’s Tax Proposals

DATE: February 19, 2010

On February 1, 2010, the Treasury published the "General Explanations of the Administration's FY 2011 Revenue Proposals” (the “2011 Green Book”), setting forth tax policy objectives of the Obama Administration (“the Administration”).

Several highlights from the 2011 Green Book are worth noting:

- The proposed tax rate hikes and the reduced deductions for high-income individual taxpayers remain unchanged and continue to be on track to take effect after 2010.

- The 2011 Green Book does not contain a proposal which would limit the availability of a check-the-box election with respect to certain wholly-owned foreign entities.

- Only interest expense that is properly allocated and apportioned to a taxpayer’s foreign-source income that is not currently subject to U.S. tax are deferred under the 2011 Green Book. Previously in the 2010 Green Book, all expenses other than research and development expenses were subject to deferral.

- Provisions tightening the earnings stripping limitations to interest expense would be directed only to expatriated entities that were formerly U.S. companies. Under the provision, the current law debt-to-equity safe harbor of 1.5 to 1 would be eliminated for expatriated entities and the 50% adjusted taxable income threshold for the limitation would be reduced to 25%. The carryforward for disallowed interest would be limited to ten years and the carryforward of excess limitation would be eliminated.

- ❑ Foreign financial institutions would be required to enter into an agreement with the I.R.S. to disclose U.S. account holders or they would face a 30% withholding tax on certain U.S. source income and payments. Certain other foreign non-financial institution entities would be subject to similar disclosure requirements but only with respect to 10% U.S. equity holders.

- ❑ Increased compliance requirements and penalties remain a major focus of the Administration.

- ❑ Carried (profits) interest received in exchange of services performed for a partnership will continue to be subject to self-employment tax. In addition, partnership gains allocated on account of such carried interest will be ordinary income in all instances. Gains from the sale of such carried interest do not qualify for the capital gain treatment.

This memorandum, prepared by Doris S. Hsu, Deborah J. Jacobs and Janine Burman, provides an overview of key Administration tax proposals in the 2011 Green Book. We trust this overview provides insight into the practical aspects of the thought process behind the Administration's proposals.

1. CONTINUATION OF CERTAIN EXPIRING PROVISIONS THROUGH 2011

A number of temporary tax provisions are scheduled to expire before December 31, 2011. The Administration proposes to extend a number of these provisions through December 31, 2011. These provisions include:

a. the optional deduction for State and local general sales taxes,

b. the Subpart F "active financing" and "look-through" exceptions under which certain interest, dividends, and royalties derived by C.F.C.'s from related parties are not characterized as Foreign Personal Holding Company Income,,

c. the exclusion from unrelated business income of certain payments to controlling exempt organizations,

d. the modified recovery period for qualified leasehold improvements and qualified restaurant property,

e. incentives for empowerment and community renewal zones, and

f. several trade agreements, including the Generalized System of Preferences and the Caribbean Basin Initiative.

In accordance with the President's agreement at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels, temporary incentives provided for the production of fossil fuels would be allowed to expire as scheduled under current law.

2. CORPORATE, PARTNERSHIP AND FINANCIAL PROVISIONS

a. Require Accrual of Income on Forward Sale of Corporate Stock

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 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, however, recognize interest income upon the current sale of its own stock for deferred payment.

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 is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for forward contracts entered into after December 31, 2011.

b. Require Ordinary Treatment for Certain Dealers of Equity Options and Commodities

The Administration proposes to treat dealers in Code §1256 contracts as receiving ordinary income from their dealer activities, rather than 60% long term capital and 40% short term capital. The dealers singled out for this revised treatment are (i) commodities dealers, (ii) commodities derivatives dealers, (iii) dealers in securities, and (iv) options dealers. This proposal could significantly change the market dynamics of the regulated commodities and futures markets. Note that dealers would have symmetry between gains and losses rather than faced with net capital losses that could go unutilized.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for taxable years beginning after the date of enactment.

c. Modify Definition of Control for Purposes 249 Deduction Limit

Code §249 denies or limits the deduction for any premium paid by a corporation when it repurchases a debt instrument that could be converted into its own stock, or stock of a corporation controlled by it, or stock of a corporation which controls it. The Administration proposes to expand the definition of control for purposes of this provision to include a parent-subsidiary group (Code §1563(a)(1)) where indirect control may exist.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective on the date of enactment.

d. Repeal Gain Limitation for Dividends Received in Reorganization Exchanges

Under Code § 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 Code § 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.

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 Code § 356(a)(2).

The proposal is similar to the proposal set forth in the 2010 Green Book of last year except that the current proposal would apply to all reorganizations (rather than limited to reorganizations where the acquiring corporation is foreign). The proposal would be effective for taxable years beginning after December 31, 2010.

e. Tax Carried (Profits) Interests as Ordinary Income

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.

Under the proposal, a partner's share of income on a "services partnership interest" (an "SPI") would be subject to tax as ordinary income, regardless of the character of the income at the partnership level. In addition, the proposal would require the partner to pay self-employment taxes on such income. Gain recognized on the sale of an SPI would generally be taxed as ordinary income, not as capital gain.

An SPI is a carried interest held by a person who provides services to the partnership. To the extent that the partner who holds an SPI contributes "invested capital" and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest, income attributable to the invested capital would not be recharacterized. Similarly, the portion of any gain recognized on the sale of an SPI that is attributable to the invested capital would be treated as capital gain. "Invested capital" is defined as money or other property contributed to the partnership. To close an anticipated loophole for round trip funding of a service partner's capital, contributed capital that is attributable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership is not treated as "invested capital."

In addition, 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 or stock in certain taxable corporations). 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 is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for taxable years beginning after December 31, 2010.

f. <u>Codify "Economic Substance" Doctrine</u>

The economic substance doctrine has developed as a common law doctrine over several years. Modern day developments of the doctrine have driven off of two key cases, *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978) and *Rice's Toyota World v. Commr.*, 752 F.2d 89 (4th Cir. 1985). Taken together, these cases stand for the proposition that economic substance is contingent on, (i) a business purpose for the transaction other than tax and (ii) a reasonable possibility of a profit.

Over the years, the economic substance doctrine emanating from these two cases distinguished two sets of rules that depend on the circumstances of the case. If the case involves a generic tax shelter product that is marketed to taxpayers, the cases asked whether the transaction itself had economic substance. On the other hand, if the case involved an internal restructuring transaction to achieve tax another goals, the cases typically reflect a substance-over-form or step transaction approach to determine which set of tax rules would be applicable.

The Administrations proposes to disregard for income tax purposes any transaction that does not have economic substance. To have economic substance, a transaction would be required to (i) change a taxpayer's economic position in a meaningful way apart from tax considerations and (ii) have a substantial non-tax purpose. In order to meet the second condition, a transaction must generate substantial present value pretax profits in relation to present value tax benefits to have a substantial non-tax purpose. Treasury regulations are authorized to provide more technical rules.

If a transaction does not have economic substance, a 30% penalty would be imposed on the understatement of tax due to the transaction, with the penalty reduced to 20% if proper disclosure of the relevant facts of transaction is made on the taxpayer's tax return. The I.R.S. could assert the penalty independently of any court proceeding. It could also abate the penalty. No deduction would be allowed for interest related to the underpayment of tax.

This proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for transactions entered into after the date of enactment. The denial of an interest deduction would be effective for taxable years ending after the date of the enactment for transactions entered into after that date.

3. REFORM THE U.S. INTERNATIONAL TAX SYSTEM

a. Defer Deduction of Interest Expense Related to Deferred Income

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 U.S. 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.

The proposal would defer the deduction of interest expense that is properly allocated and apportioned to a taxpayer’s foreign-source income that is not currently subject to U.S. tax. For purposes of 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. Deferred interest expense would be deductible in a subsequent tax year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during that subsequent tax year.

The proposal in the 2011 Green Book affects only interest expense. This is a major modification of the proposal that appeared in the 2010 Green Book, which attacked all expenses other than research and development expenses. The provision would be effective for taxable years beginning after December 31, 2010.

b. Foreign Tax Credit Reform: Determine the Foreign Tax Credit on a Pooling Basis

Code §901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income taxes paid or accrued to a foreign country or any possession of the U.S. Under Code §902, a domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend. This is known as the deemed-paid foreign tax credit, because the U.S. parent corporation is deemed to have paid the taxes of the foreign subsidiary at the time dividends are distributed. A similar credit applies to income inclusions under Subpart F - a U.S. parent corporation may claim a credit for the taxes paid by the controlled foreign corporation. 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 Code 904(d), *i.e.*, the passive category and general category.

Under the proposal, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis by determining 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 Code 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year. The provision is designed to prevent taxpayers from planning dividend flow from specific companies in order to maximize the benefit of the foreign tax credit. In essence, aiming before shooting is viewed to be problematic. Instead, a blunderbuss shotgun approach to planning is preferred.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for taxable years beginning after December 31, 2010.

c. Prevent Splitting of Foreign Income and Foreign Taxes

Code §901 provides that 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 U.S. Under current law, the person considered to have paid the foreign tax is the person on whom foreign law imposes legal liability for such tax.

It is sometimes possible, using hybrid arrangements, to have legal liability for a foreign tax to be imposed on a U.S. person even though a foreign person recognizes the income under U.S. tax principles. The proposal would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for taxable years after December 31, 2010.

d. Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore

Code § 482 authorizes the I.R.S. 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 to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The Administration believes that 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. Under the proposal, if a U.S. person transfers an intangible from the U.S. to a related controlled foreign corporation that is subject to a low foreign effective tax rate in circumstances that evidence excessive income shifting, then an amount equal to the excessive return would be treated as subpart F income in a separate foreign tax credit limitation basket.

The proposal would be effective for taxable years beginning after December 31, 2010.

e. Limit Shifting of Income Through Intangible Property Transfers

Code § 482 permits the I.R.S. 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." Code § 482 also provides that in the case of any transfer of intangible assets, the income with respect to the transaction must be commensurate with the income attributable to the intangible assets transferred. Further, under Code § 367(d), if a U.S. person transfers intangible property (as defined in Code § 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.

To prevent inappropriate shifting of income outside the U.S., the proposal would clarify the definition of intangible property for purposes of Code §§ 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 is unchanged from the proposal set forth in the 2010 Green Book of last year except that the current proposal does not require the valuation at the highest and best use. The proposal would be effective for taxable years beginning after December 31, 2010.

f. Disallow the Deduction for Excess Non-taxed Reinsurance Premiums Paid to Affiliates

Insurance companies are generally allowed a deduction for premiums paid for reinsurance. 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 U.S. 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% of the premiums paid, unless waived by treaty.

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 U.S.

Under the proposal, a U.S. insurance company would not be allowed a deduction to the extent that (1) the foreign reinsurers (or their parent companies) are not subject to U.S. income tax with respect to premiums received and (2) the amount of reinsurance premiums (net of ceding commissions) paid to foreign reinsurers exceeds 50% of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business. The proposal also provides that a foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this provision may elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the U.S.

The provision is effective for taxable years beginning after December 31, 2010.

g. Limit Earnings Stripping by Expatriated Entities

Code § 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% of adjusted taxable income. 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 may be carried forward to the 3 subsequent tax years.

Code § 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 surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code if shareholder ownership continuity is at least 80% (by vote or value). If shareholder ownership continuity is at least 60%, but less than 80%, the surrogate foreign corporation is treated as a foreign corporation but any applicable corporate-level income or gain required to be recognized by the expatriated entity generally cannot be offset by tax attributes. Code § 7874 generally applies to transactions occurring on or after March 4, 2003.

The proposal would revise Code § 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% adjusted taxable income threshold for the limitation would be reduced to 25%. 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 Code § 7874 and the regulations thereunder as if Code § 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 Code § 7874.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year except that the reduced 25% adjusted taxable income threshold would apply to all disqualified interest under the current proposal. The proposal would be effective for taxable years beginning after December 31, 2010.

h. Repeal 80/20 Company Rules

Dividends and interest paid by a domestic corporation are generally U.S.-source income to the recipient and are generally subject to gross basis withholding tax if paid to a foreign person. A limited exception to these general rules applies with respect to a domestic corporation (a so-called "80/20" company) if at least 80% of the corporation's gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business. Look-through rules apply to determine the character of certain income of the 80/20 company for this purpose.

The proposal would repeal the 80/20 company provisions under current law.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for taxable years beginning after December 31, 2010.

i. Prevent the Avoidance of Dividend Withholding Taxes

Foreign investors holding stock in domestic corporations are generally subject to a 30% withholding tax on dividends paid with respect to that stock. This rate may be reduced where the dividends are paid to a resident of a jurisdiction with which the U.S. has entered into a tax treaty. The source of income from a notional principal contract is generally determined based on the residence of the investor. As a result, substitute dividend payments made to a foreign investor with respect to an equity swap referencing U.S. equities are treated as foreign-source and are therefore not subject to U.S. withholding tax.

The proposal would treat the income earned by foreign persons with respect to equity swaps that reference U.S. equities as U.S.-source to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. An exception to this source rule would apply to swaps which are unlikely to reflect avoidance of U.S. gross-basis taxation.

The proposal is similar to the proposal set forth in the 2010 Green Book of last year (though without specifically revoking Notice 97-66). The proposal would be effective for payments made after December 31, 2010.

j. Modify the Tax Rules for Dual Capacity Taxpayers

Code § 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income taxes paid or accrued during the taxable year to any foreign country or any possession of the U.S. To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under U.S. 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 Code § 904 foreign tax credit basket for oil and gas income. However, under Code § 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.

In the case of a dual capacity taxpayer, the proposal would allow the 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 Code § 907 into a separate category within Code § 904 for foreign oil and gas income. The proposal would yield to U.S. treaty obligations to the extent that they allow a credit for taxes paid or accrued on certain oil or gas income.

The proposal is similar to the proposal set forth in the 2010 Green Book of last year though it does not fucus solely on countries that do not impose an income tax. The proposal would be effective for taxable years beginning after December 31, 2010.

4. COMBAT UNDER-REPORTING OF INCOME ON ACCOUNTS AND ENTITIES IN OFFSHORE JURISDICTIONS

a. Require Increased Reporting on Certain Foreign Accounts

The Administration is concerned about the use of offshore accounts and entities by U.S. and foreign persons to evade U.S. income tax. Under current law, a withholding agent generally must withhold tax at a rate of 30% from the gross amount of all U.S.-source fixed or determinable annual or periodical gains, profits, or income ("FDAP income") of a nonresident, non-citizen individual or foreign entity. This 30% withholding tax may be reduced or eliminated pursuant to certain statutory provisions or pursuant to the terms of a tax treaty. In addition, a payor is generally required to withhold tax at a rate of 28% on a reportable payment made to a U.S. non-exempt recipient (i.e., a foreign corporation or a nonresident, non-citizen individual) if the payee fails to provide a taxpayer identification number or fails to certify, when required, that the payee is not subject to backup withholding, or the payor is notified by the I.R.S. or a broker that the payee is subject to backup withholding.

To determine whether the recipient of a payment is exempt from withholding tax or eligible for a reduced rate, withholding agents generally must rely on beneficial ownership documentation provided by the payee certifying that the payee is entitled to an exemption from withholding tax or a reduced rate of withholding tax under a Code provision or relevant tax treaty. In general, withholding agents are entitled to rely on the self certification they receive absent actual knowledge or reason to know that the information provided is incorrect or unreliable. In the case of payments made through an intermediary, the intermediary generally provides to the withholding agent the appropriate documentation on behalf of the payment's beneficial owners.

Treasury regulations specifically address certification, documentation, withholding, and reporting of payments to U.S. and foreign persons through foreign financial institutions ("FFIs"). Under the qualified intermediary ("QI") program, a foreign financial institution may contract with the I.R.S.

to operate under a set of withholding and reporting rules that are designed to ensure the proper U.S. taxation of income earned or held through offshore fiduciary accounts or nominee entities. QIs agree to collect identifying documentation from their customers, file withholding tax returns and information returns, and submit to periodic audits performed by external auditors supervised by I.R.S. examiners. QIs may furnish a withholding certificate to a withholding agent in lieu of transmitting to the withholding agent documentation for persons for whom the QI receives the payment and, in the case of U.S. non-exempt recipients, may assume primary Form 1099 reporting and backup withholding responsibility.

Under the Administration's proposal, a withholding agent would withhold tax at a rate of 30% on payments to a FFI (including certain entities engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interests in the foregoing) of U.S.-source FDAP income and gross proceeds from the sale of any property of a type which can produce U.S.-source interest or dividends, unless the FFI has entered into an agreement with the I.R.S. The agreement would require the FFI to identify accounts (including debt and equity securities issued by the FFI that are not regularly traded on an established securities market) held at such FFI or at an FFI in the same expanded affiliated group by specified U.S. persons or by foreign entities in which a specified U.S. person owns, directly or indirectly, an interest of more than 10% (a U.S. owned foreign entity). The FFI would be required to report the name, address, and taxpayer identification number ("TIN") of the U.S. account holder (or each substantial U.S. owner of the U.S. owned foreign entity account holder), the account balance or value, and the gross receipts and gross withdrawals or payments from the account. Instead of reporting the account balance and the gross receipts and gross withdrawals or payments from the account, a FFI may elect to report such information as such FFI would be required to report under Code §§ 6041, 6042, 6045, and 6049 if such FFI were a U.S. person and each holder of such accounts that is a specified U.S. person or a U.S. owned foreign entity were a natural person and citizen of the U.S.

This proposal would not apply to a payment if the beneficial owner is a foreign government, an international organization, a foreign central bank, or any other class of persons that the Treasury Department concludes presents a low risk of tax evasion. The Treasury Department would be authorized to issue regulations to implement the purposes of this proposal. The rules would be designed so as not to disrupt ordinary and customary market transactions. Foreign beneficial owners of payments (other than FFIs that do not qualify for the benefits of an income tax treaty with the U.S.) that are subject to withholding tax in excess of the income tax liability as a result of this proposal would be permitted to apply for a refund of any excess tax withheld.

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

b. <u>Require Increased Reporting with Respect to Certain Recipients of FDAP Income or Gross Proceeds</u>

Under current law, payments of U.S.-sourced FDAP income to nonresident, non-citizen individuals and foreign entities are subject to a withholding tax at a rate of 30%, which may be reduced or eliminated pursuant to certain statutory provisions or pursuant to the terms of a tax treaty. In order to determine whether a recipient of a payment is exempt from withholding tax or eligible for a reduced rate of tax, withholding agents must rely on beneficial ownership documentation provided by the payee certifying that the payee is entitled to an exemption from withholding tax or a reduced rate of withholding tax. Withholding agents are entitled to rely on the self-certification they receive absent actual knowledge or reason to know that the information provided is incorrect or unreliable. In the case of payments made through an intermediary, the intermediary generally provides to the withholding agent the appropriate documentation on behalf of the payment's beneficial owners.

Brokers are generally required to withhold tax at a rate of 28% on certain reportable payments made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number or fails to certify that the payee is not subject to backup withholding, or the payor is notified by the I.R.S. or a broker that the payee is subject to backup withholding. Reportable payments include the gross proceeds from certain transactions effected by brokers for their customers. However, a broker is exempt from reporting a payment (and thus from backup withholding) if the broker can, prior to payment, associate the payment with documentation upon which it can rely to either treat the customer as a foreign beneficial owner, or treat the payment as if made, or presumed to be made, to a foreign payee. That is the reason why brokers insist on the receipt of an original Form W-8BEN properly executed before any payments are made to a foreign entity. With respect to payments made through foreign intermediaries that are not qualified intermediaries ("nonqualified intermediaries"), brokers may rely on the beneficial owner's self-certification of non-U.S. status passed on by the nonqualified intermediary to determine whether certain third-party information reporting, and therefore, backup withholding, may be required.

The Administration is concerned that some persons not entitled to an exemption from withholding tax or a reduced rate of withholding tax may attempt to avoid U.S. tax by arranging to receive payments through foreign intermediaries that are not qualified intermediaries ("nonqualified intermediaries"). Under the proposal, any withholding agent making a payment of FDAP income and gross proceeds from the sale of any property of a type which can produce U.S.-source interest or dividends to a foreign entity (other than a FFI) would be required to treat the payment as if made to an unknown foreign person and therefore subject to the 30% withholding tax unless the foreign entity certifies that no U.S. person owns, directly or indirectly, an interest of more than 10% or the foreign entity provides the name, address, and TIN of each such substantial U.S. owner, and the withholding agent does not know or have reason to know that any information provided is incorrect. Exceptions would be provided for payment to publicly traded companies and their subsidiaries, foreign governments, international organizations, foreign central banks, any entity that is organized under the laws of a possession of the U.S. and that is wholly owned by one or more bona fide residents of such possession, and other classes of person identified by the Secretary, or any class of payment identified by the Secretary, as posing a low risk of tax evasion.

This proposal would be effective for payments made after December 31, 2012.

c. <u>Repeal Certain Foreign Exceptions to Registered Bond Requirements</u>

Under current law, a taxpayer may generally deduct all interest paid or accrued within the taxable year on indebtedness. However, for registration-required obligations, a deduction for interest is allowed only if the obligation is in registered for. An obligation is generally treated as issued in registered form if the issuer or its agent maintains a registration of the identity of the owner of the obligation and the obligation can be transferred only through this registration system.

If an obligation that is a registration-required obligation is not in registered form, then an excise tax also is imposed on the issuer of the obligation. The excise tax is equal to 1% of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) during the period beginning on the date of issuance of the obligation and ending on the date of maturity. In addition, any gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation is treated as ordinary income (rather than capital gain), unless the issuer of the obligation was subject to the excise tax described above. Finally, deductions for losses realized by the beneficial owners of registration-required obligations that are not in registered form are disallowed.

Under current law, a foreign targeted obligation is excluded from the definition of a registration-required obligation. Moreover, payments of "portfolio interest" are generally exempt from U.S. withholding tax to a nonresident alien or foreign corporation from sources within the U.S. Interest on an obligation that is not in registered form may qualify as portfolio interest if the obligation meets the foreign targeting requirements of Code § 163(f)(2)(B).

Under the Administration's proposal, the foreign targeted obligation exception would be repealed. Thus, a deduction for interest would be disallowed with respect to any registration-required obligation not issued in registered form. Under the proposal, a dematerialized book entry system or other book entry system specified by the Secretary would be treated as a book entry system for purposes of determining whether an obligation is in registered form. Moreover, the foreign targeted obligation exception would not be available with respect to gain on the sale or disposition of an obligation, or with respect to the deduction for losses. Finally, under the proposal, interest paid on bonds that are not issued in registered form would not be treated as portfolio interest.

This provision would be effective for obligations issued after the date which is two years after the date of enactment.

d. <u>Require Disclosure of Foreign Financial Assets to be Filed with Tax Return</u>

Under current law, taxpayers generally must indicate on their income tax returns whether they had an interest in or signature or other authority over a financial account in a foreign country during the year to which the tax return relates. If a taxpayer has a foreign account, the tax return refers the taxpayer to the Report of Foreign Bank and Financial Accounts, Form TD F 90-22.1 (FBAR). The FBAR requires the taxpayer to disclose whether, at any time during the preceding year, that person had an interest in, or signature authority over, financial accounts, if the aggregate value of these accounts exceeds $10,000. The FBAR further requires the person to disclose certain information regarding the foreign account, including the account number, financial institution, and maximum value during the year. The FBAR is not required to be filed until June 30 of the year following the calendar year to which it relates, and is filed with the Treasury Department and not the I.R.S.

The Administration's proposal would require any U.S. individual who holds an interest in a foreign financial account, an interest in a foreign entity or any financial instrument or contract held for investment and issued by a foreign person would be required to file an information return if the aggregate value of all such assets exceeds $50,000. The information return would set forth the name and address of the financial institution that maintains such account or the issuer of the instrument, and the maximum value of the asset during the year. The disclosure would be included as part of the tax return for the taxpayer. Penalties for failing to report the foreign financial asset would be consistent with current penalties under current law for failing to disclose an interest in a foreign entity, such that a failure to report the required information would result in a penalty of $10,000, unless the failure is shown to be due to reasonable cause and not willful neglect.

A rebuttable evidentiary presumption would be applicable in a civil administrative or judicial proceeding providing that, if it is established that the individual had an interest in an undisclosed foreign financial asset, then the aggregate value of all foreign financial assets in which a U.S. individual has an interest will be presumed to exceed $50,000. The rebuttable evidentiary presumption would not apply in criminal proceedings.

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

e. <u>Impose Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets</u>

Under current law, there is a 20% accuracy-related penalty imposed on (i) a substantial understatement of income tax, (ii) an understatement resulting from negligence or disregard of rules or regulations, and (iii) an understatement related to a reportable transaction. The 20% penalty increases to 30% in the case of an understatement from a reportable transaction that was not properly disclosed. If "reasonable cause" and good faith exist, the penalty is not imposed. However, in the case of a reportable transaction, the reasonable cause exception applies only if the taxpayer disclosed the reportable transaction as required by law and certain other requirements are met. Current law also provides that taxpayers must indicate on their income tax returns whether they had an interest in or signature or other authority over a financial account in a foreign country. If the taxpayer had a foreign financial account, the income tax return instructs the taxpayer to refer to the FBAR, which requires the taxpayer to disclose information regarding certain foreign accounts.

In addition to the circumstances identified under current law, the 20% accuracy-related penalty would apply to any understatement attributable to undisclosed foreign financial assets. In addition, in an effort to discourage U.S. persons from evading U.S. tax liability by transferring assets to foreign accounts, the Administration has proposed doubling the 20% accuracy-related penalty to 40% in the case of such foreign financial asset understatements. Undisclosed foreign financial assets would be foreign financial assets that the taxpayer failed to disclose properly under Code §§ 6038, 6038B, 6046A, 6048, or the proposed required that taxpayers disclose foreign financial assets. As under current law, the penalty would not be imposed when the understatement is due to reasonable cause.

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

f. Extend Statute of Limitations for Significant Omission of Income Attributable to Foreign Financial Assets

Under current law, the I.R.S. has three years after the date a return is filed to assess additional Federal tax liabilities in the form of tax, interest, penalties, and addition to tax. If an assessment is not made within the required time period, the additional liabilities generally cannot be assessed or collected at any future time. However, Code § 6501(c)(8) provides an exception to this general statute of limitations with respect to any tax relating to any event or period for which certain information returns are required with respect to certain foreign transfers, foreign entities, and foreign-owned entities. In these cases, the statute of limitations does not expire until three years after the taxpayer furnishes the information required to be reported.

In addition, Code §6038A requires certain foreign-owned domestic corporations to file information returns containing specified information with respect to related-party transactions and to maintain such records as may be appropriate to determine the correct treatment of such transaction. The failure to file the required information triggers an extension to the statute of limitations under Code §6501(c)(8).

A special rule is provided where there is a substantial omission of income. If a taxpayer omits substantial gross income on a return, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed. In the case of income taxes, a substantial omission means at least 25 % of the amount that was properly includible in gross income; for estate and gift taxes, a substantial omission means 25% of a gross estate or total gifts.

The Administration believes that the applicable three-year statute of limitations provided by Code § 6501(c)(8) does not always allow sufficient time for the I.R.S. to determine a taxpayer's tax liability where the taxpayer has omitted income and failed to disclose foreign assets. Thus, under the Administration's proposal, if the taxpayer omits from gross income more than $5,000 that is attributable to one or more foreign financial assets required to be disclosed under the proposal to require disclosure of foreign financial assets (without regard to the $50,000 threshold), the state of limitation would be extended to six years after the required return was filed. In addition, the tolling of the statute of limitations under Code §6501(c)(8) would apply to failures to file the reports that would be required under the proposal to require reporting of foreign financial assets.

This proposal would be effective for income tax returns due to be filed after the date of enactment, and returns filed on or before such date if the statute of limitation with respect to such return has not expired as of the date of enactment.

g. Require Reporting of Certain Transfers of Assets to or From Foreign Financial Accounts

Under current law, a U.S. person must disclose whether, at any time during the preceding year, the person had an interest in, or signature or other authority over, financial accounts in a foreign country. The reporting obligation is triggered if the aggregate value in these accounts exceeds $10,000. Moreover, a U.S. person must also report this information when the account is held by a foreign business entity that they control. For example, a U.S. person is treated as controlling a foreign corporation for this purpose if the person owns, actually or constructively, more than 50% of the corporation's stock, by vote or by value. Current law does not require the reporting of transfers of money or property to, or receipt of money or property from, a foreign bank, brokerage, or other financial account by U.S. individuals.

Under the Administration's proposal, a U.S. individual would be required to report, on the individual's income tax return, any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual. Additionally, any entity of which a U.S. individual owns, directly or indirectly, more than 25% of the ownership interest would be required to report any transfer of money or property made to, or receipt of money or property from any foreign bank, brokerage, or other financial account by the entity. Such an entity would also be required to report the name, address, and taxpayer identification number of any U.S. individual who owns more than 25% of the ownership interest in the entity. This reporting requirement would not apply if the cumulative amount or value of transfers, and the cumulative amount or value of receipts that would otherwise be reportable for a given year were each less than $50,000. The Treasury Department would receive regulatory authority to require the reporting of additional information, including classifying transfers and receipts as for investment or for arm's-length payments in the ordinary course of business for services or tangible property or such other categories as the Secretary may prescribe. Failure to report a covered transfer would result in the imposition of a penalty equal to the lesser of $10,000 per reportable transfer or 10% of the cumulative amount or value of the unreported covered transfers. No penalty would be imposed for a failure to report due to reasonable cause.

The Treasury Department would receive regulatory authority to issue anti-abuse rules and to provide exceptions to the reporting requirement.

This proposal would be effective for transfers made after December 31, 2012.

h. Require Third-Party Information Reporting Regarding the Transfer of Assets to or from Foreign Financial Accounts and the Establishment of Foreign Financial Accounts

A U.S. person must disclosure whether, at any time during the preceding year, they had an interest in, or signature or other authority over, financial accounts in a foreign country, if the aggregate value of these accounts exceeds $10,000. Current law does not generally require third-party information reporting to the I.R.S. with regard to the transfer of money or property to, or receipt of money or property from, a foreign bank, brokerage, or other financial account on behalf of a U.S. person, or with regard to the establishment of a foreign bank, brokerage, or other financial account on behalf of a U.S. person, or with regard to the establishment of a foreign bank, brokerage, or other financial account on behalf of a U.S. person.

In order to ensure compliance with the requirement to report certain foreign financial accounts, the Administration's proposal seeks to establish a third-party reporting requirement. Under this proposal, any U.S. financial institution that during the year transfers to, or receives from, a foreign bank, brokerage, or other financial account or property with a value of more than $50,000 on behalf of a U.S. individual (or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25% of the ownership interest) would be required to file an information return regarding such transfer (or receipt), including, in the case of a transfer by an entity, the name, address, and TIN of any U.S. individual who owns more than 25% of the ownership interest in such entity. In addition, any U.S. financial institution that opens a foreign bank, brokerage, or other financial account on behalf of a U.S. individual (or on behalf of any entity of which a U.S. individual owns, actually or constructively, more than 25% of the ownership interest) would be required to file an information return with the I.R.S. regarding such account, including reporting any amounts of money or property transferred by the financial institution to, or received by it from, such account.

In addition to filing an information return with the I.R.S., the U.S. financial institution would be required to send a copy of such return to the U.S. individual, or entity, as to which the return is made.

Exceptions to the reporting requirement would be provided where the U.S. financial institution determined the entity making or receiving the transfer was one of the following: (1) a publicly traded corporation or a subsidiary thereof; (2) an organization exempt from tax under Code §501; (3) an individual retirement plan; (4) the U.S. or any wholly owned agency or instrumentality thereof; (5) any State, the District of Columbia, any possession of the U.S., any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing; (6) any bank; (7) and real estate investment trust; (8) any regulated investment company; (9) any common trust fund; (10) any trust which is exempt from tax; or (11) an entity engaged in an active trade or business (other than the business of investing or similar activities).

Failure to file a required information return or to provide a copy of such return to the U.S. individual would result in the imposition of a penalty of $50 with respect to each such failure. In the case of a failure to file due to intentional disregard, the penalty would be the greater of $100 or 5% of the amount of the items required to be reported. No penalty would be imposed for a failure to report due to reasonable cause.

This proposal would be effective for amounts transferred and accounts opened beginning after December 31, 2012.

i. Permit the Secretary to Require Electronic Filing by Financial Institutions of Certain Withholding Tax Returns

Under current law, every withholding agent must file an annual return with the I.R.S. on Form 1042, reporting all taxes withheld during the preceding year and remitting taxes still owning for such preceding year. A withholding agent also must file an information return on Form 1042-S, providing all items of income specified in Code §1441(b) paid during the previous year to foreign persons.

At present, the Secretary cannot require people to file electronically unless that person is required to file at least 250 returns during the year. Given that electronic filing reduces errors on the required returns and facilitates compliance and enforcement measures by the I.R.S., the Administration's proposal would permit the Treasury Department to issue regulations requiring electronic filing for any return filed by a financial institution with respect to taxes withheld by the financial institution, regardless of the general 250 return threshold.

This proposal would apply to returns the due date for which (determined without regard to extensions) is after the date of enactment.

j. Establish Presumption of U.S. Beneficiary in Case of Transfer to Foreign Trusts by a U.S. Person

Under current law, a U.S. person that directly or indirectly transfers property to a foreign trust is generally treated as the owner of the portion of the trust attributable to that property for any year in which there is a U.S. beneficiary of any portion of the trust. A trust is treated as having a U.S. beneficiary for a taxable year unless under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, and if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.

In the absence of adequate information reporting, it is difficult for the I.R.S. to determine whether a trust has a U.S. beneficiary. Thus, the Administration's proposal would establish a presumption of a U.S. beneficiary. Under the proposal, if a U.S. person directly or indirectly transfers property to a foreign trust (other than certain deferred compensation and charitable trusts), the trust would be presumed to have a U.S. beneficiary for purposes of the grantor trust rules unless the U.S. transferor files an information return with the I.R.S. and demonstrates that (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of any U.S. person. The proposal would also make certain clarifications of existing rules applicable to foreign trusts with U.S. grantors and beneficiaries.

This proposal would be effective for transfers of property made after the date of enactment.

k. <u>Treat Certain Uncompensated Uses of Foreign Trust Property as a Distribution to U.S. Grantor or Beneficiary</u>

Under current law, if a foreign trust makes a loan of cash or marketable securities directly or indirectly to any grantor or beneficiary of the trust who is a U.S. person, or to any U.S. person related to such grantor or beneficiary, the amount of the loan is treated as a distribution by the foreign trust to the grantor or beneficiary. In addition, the trust is not treated as a simple trust for the year of the distribution. The grantor trust rules do not currently treat a U.S. person receiving an uncompensated loan of cash or marketable securities, or the uncompensated use of trust property, as a U.S. beneficiary.

The Administration is concerned that foreign trusts may permit the uncompensated use of trust property by U.S. persons without treating the value of the use as a trust distribution, and without treating the recipient as a U.S. beneficiary for purposes of the grantor trust rules. Under the Administration's proposal, if a foreign trust permits the use of trust property other than cash or marketable securities by a U.S. grantor or beneficiary (or a related U.S. person), the fair market value of the use of such property would be treated as a distribution to the U.S. grantor or beneficiary, except to the extent that the trust is paid the fair market value of such use within a reasonable period of time. In addition, for purposes of the grantor trusts rules, a loan of cash or marketable securities or the use of other property of a foreign trust would be treated as paid or accumulated for the benefit of a U.S. person, except to the extent that the U.S. persons repays the loan at market rates (or pays the fair market value of the use) within a reasonable period of time.

This proposal would be effective for loans made, and uses of property, after the date of enactment.

l. <u>Improve the Foreign Trust Reporting Penalty</u>

Under current law, certain information must be reported to the I.R.S. with respect to certain foreign trusts. A civil penalty, generally equal to 35% of the "gross reportable amount," applies to persons who fail to file a timely return as required or who file an incomplete or incorrect return. The "gross reportable amount" is defined as the gross value of property involved in a reportable event such as a gratuitous transfer to the trust, the gross value of the portion of the trust's assets at the close of the year that is treated as owned by a U.S. person, or the gross amount of distributions received from the trust. In the case of a failure to report (which continues for more than 90 days after the I.R.S. mails notice of such failure), the penalty (in addition to the 35% penalty) is $10,000 for each 30-day period (or fraction thereof) during which the failure continues. Under current law, the total penalty with respect to any failure may not exceed the gross reportable amount.

In many instances, it is difficult for the I.R.S. to determine the gross reportable amount without the cooperation of the persons involved with the trust. Under the Administration's proposal, the penalty provision would be amended to impose an initial penalty of the greater of $10,000 or 35% of the gross reportable amount (if it is known). The additional $10,000 penalty for continued failure to report would remain unchanged. Under this proposal, the I.R.S. may impose a $10,000 penalty on a person who fails to report timely or correctly as required, even if the gross reportable amount is unknown. In addition, the I.R.S. may continue to impose an additional $10,000 penalty for each 30-day period (or fraction thereof) that the failure to report continues. If the person subsequently provides enough information for the I.R.S. to determine the gross reportable amount, the total penalties would be capped at that amount and any excess penalty already paid would be refunded. Accordingly, a person can stop the compounding of penalties by cooperating with the I.R.S. so that it can determine the gross reportable amount.

This proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for information reports required to be filed after December 31 of the year of enactment.

m. Hiring Incentives to Restore Employment Act

In another legislative development, on February 11, 2010, Senate Finance Committee Chair Max Baucus, D-Mont, and ranking minority member Chuck Grassley, R-Iowa, released a draft of the Hiring Incentives to Restore Employment Act. In a February 11, 2010 release, they stated that "The draft contains proposals we would expect to be include in an initial bill." Included in this draft legislation as one of several offsets are provisions in a section entitled the "Foreign Account Tax Compliance". These provisions include a comprehensive set of measures to reduce offshore noncompliance by giving the I.R.S. new administrative tools to detect, deter and discourage offshore tax abuses. The proposals include the following: (1) 30% withholding on U.S. source payments to foreign financial institutions, foreign trusts, and foreign corporations that do not agree to disclose their U.S. account holders and owners to the I.R.S.; (2) requiring taxpayers to disclose their foreign accounts on their U.S. tax returns; (3) increasing the statute of limitations to 6 years for failure to report certain offshore transactions and income; (4) clarifying when a foreign trust is considered to have a U.S. beneficiary; and (5) treating substitute dividend and dividend equivalent payments to foreign persons as dividends for purposes of U.S. withholding.

5. STRENGTHEN TAX ADMINISTRATION

a. Treatment of Criminal Tax Restitution Orders

In a criminal tax case, the tax that is avoided may be treated as the equivalent of a theft of property from the government. As a result, a Court may order the defendant to make a restitution payment, as in any other theft action. To facilitate collection of the debt created under the order, the Administration proposes to treat the restitution amount as a tax. This will enable the I.R.S. to collect the amount under its civil tax collection procedures.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective after December 31, 2011.

b. Offers-In-Compromise

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 I.R.S. to collect the portion of a tax liability that the taxpayer has the ability to pay. Current law requires taxpayers to make a nonrefundable payment with any initial offer-in-compromise of a tax case. If the offer involves a lump sum payment, 20% of the amount must accompany the offer. If the offer involves periodic payments over time, the fI.R.S.t installment must accompany the offer. The Administration views the nonrefundable payment as an obstacle that prevents taxpayers from using the program. Consequently, it proposes to eliminate the requirement relating to nonrefundable payments at the time of submission.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be for offers-in-compromise submitted after the date of enactment.

c. I.R.S. Access To Information Social Security Information in The National Directory Of New Hires

The National Directory of New Hires is a database that contains newly-hired employee data from Form W-4, quarterly wage data from State and Federal employment security agencies, and unemployment benefit data from State unemployment insurance agencies. It was created to help State child support enforcement agencies enforce obligations of parents across State lines. The Administration proposes to give the I.R.S. access to this 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.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective upon enactment.

d. Repeated Willful Failure To File A Tax Return

Current law provides that a 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. The Administration proposes to make the repeated willful failure to file a tax return a felony punishable by 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 is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for returns required to be filed after December 31, 2010.

e. Facilitation of Tax Compliance With Local Jurisdictions

The I.R.S. is authorized to share Federal tax information with States and certain local government entities. Generally, the purpose of information sharing is to facilitate tax administration. The Administration proposes to share information with Indian tribal governments that impose alcohol, tobacco, or fuel excise or income or wage taxes.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for disclosures made after enactment.

f. Required Electronic Filing By Tax Return Preparers

Electronic filing of tax returns is the wave of the future. The Administration proposes to authorize the I.R.S. to issue regulations that will require electronic filing of tax returns by individuals, states, or trusts.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for tax returns required to be filed after December 31, 2011.

g. Bad Check Penalty

The penalty is 2% of the bad check or money order, but only $25 for checks or money orders under $1,250. The Administration proposes to expand the scope of the penalty to cover all commercially acceptable instruments of payment that are not duly paid.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for returns required to be filed after December 31, 2010.

h. Penalty On Failure To Comply With Electronic Filing Requirements

Certain corporations and charitable organizations are required to file tax returns electronically. If a corporation fails to file electronically, it is treated as if it did not file any tax return at all. Thus, the penalty that is imposed is based on the amount of tax due. Corporations in a loss position thus face no monetary penalty. Charities are subject to minor penalties per day, that are capped generally at $10,000. The Administration proposes to revise the existing penalty structure by establishing an assessable penalty of a fixed amount. It would be $25,000 for a corporation and $5,000 for a tax-exempt organization.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective for returns required to be electronically filed after December 31, 2011.

6. ESTATE AND GIFT TAXATION REFORM

a. Consistency In Value For Estate and Income Tax Purposes

To prevent the I.R.S. from being whipsawed by estate executors who may want to choose the lowest fair market value when computing the estate tax for a decedent's estate and a beneficiary who may want to choose the highest fair market value when computing tax basis for property received from an estate, the Administration proposes the adoption of a consistency requirement between estates and beneficiaries with regard to valuation and basis. The provision is similar in concept to Code §6034A, which applies to income items distributed from a trust to a beneficiary. Most, but not all, tax planners adopt this approach currently.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would be effective as of the date of enactment.

b. Modify Rules On Valuation Discounts

The estate tax is generally based on the fair market value of the property owned at death. Several estate planning techniques commonly used by estate planners involve the adoption of restrictions that reduce the value of the decedent's property at the time of death. While Code §2704 was enacted to prevent the reduction of taxes through the use of "estate freezes" and other techniques, Courts have limited the application of that provision as it applies to interests in family owned companies. The Administration proposes to expand the application of Code § 2704 to broaden the class of restrictions that are ignored in determining the value of property owned by the decedent. Property that would be covered by the new provision would include an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction (a) will lapse or (b) may be removed by the transferor and/or the transfer's family. This property would be valued for estate tax purposes by substituting certain assumptions that will be specified by the I.R.S. in regulations. Disregarded restrictions would include (i) limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard that would be identified in regulations and (ii) any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity.

This proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and would apply to transfers, after the date of enactment, of property subject to restrictions created after October 8, 1990 (the effective date of Code § 2704).

c. Minimum Term For a Grantor Retained Annuity Trust ("GRAT")

A GRAT is a useful tool to reduce estate tax because it allows a remainder interest to be transferred to the GRAT's beneficiary, which has the effect of reducing the ultimate estate tax at the cost of a gift tax that is based on the current value of the remainder interest. All appreciation after the establishment of the GRAT is removed from the estate tax. A GRAT is formed for a term of years and for it to provide the desired tax effect, the settlor must outlive that term. If not, his taxable estate includes all the property in the GRAT. Consequently, the term of the GRAT is often set based on the age and physical condition of the settlor. Where the settlor is old or infirm, the term is shortened. While paying lip service to the usefulness of the GRAT, the Administration proposes to limit the usefulness of the GRAT as a planning tool to persons who are young and in good health. It does this by proposing that a GRAT must have a minimum term of 10 years. The proposal would also require that the remainder interest have a value greater than zero and would prohibit any decrease in the annuity during the term of the GRAT.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year except that it would also require that the remainder interest have a value greater than zero and would prohibit any decrease in the annuity during the term of the GRAT. Ths proposal would apply to trusts created after the date of enactment.

7. Upper-Income Tax Provisions

a. Reinstatement of the Highest Individual Income Tax Rates Starting 2011

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "EGTRRA") was enacted to help stimulate the economy and restore confidence after the event on September 11, 2001. The EGTRRA temporarily reduced the highest individual income tax rate of 39.6% to 35% and the second highest individual income rate of 36% to 33%, with the reduction phased in over several years. The Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the reduction and the highest individual income tax rates since 2003 have been 35% and 33%. The reduced top individual income tax rates currently sunset after 2010.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and will not extend the sunset and thus the highest individual income tax rates will revert back to 39.6% and 36% beginning 2011.

b. Reinstatement of the Limitation on Itemized Deductions Starting 2011

Prior to the enactment of the EGTRRA in 2001, itemized deductions other than medical expenses, investment interest, theft and casualty losses and gambling losses were reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeded a statutory floor but not by more than 80% of the otherwise allowable deductions. EGTRRA reduced the itemized deduction limitations for taxable years 2006 through 2009 and completely eliminated the reduction for 2010. The reduction and elimination of the itemized deduction limitation currently sunset after 2010.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and will not extend the sunset and itemized deduction limitation will revert to the pre-EGTRRA level, at 3% of the amount by which the taxpayer's adjusted gross income exceeded a statutory floor (indexed for inflation) but not by more than 80% of the otherwise allowable deductions.

c. Reinstatement of the Personal Exemption Phase-Out Starting 2011

Prior to the enactment of the EGTRRA in 2001, personal exemptions were reduced or completely phased out for higher-income taxpayers. For a taxpayer with an adjusted gross income in excess of the threshold amount, each personal exemption was reduced by 2% for each additional $2,500 of income in excess of the threshold amount. EGTRRA reduced the personal exemption phase-out for years 2006 through 2009 and completed eliminated it for 2010. The reduction and elimination of the personal exemption phase-out currently sunset after 2010.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and will not extend the sunset and the personal exemption phase-out will revert to the pre-EGTRRA level. The adjusted gross income threshold for the phase-out will be adjusted for inflation.

d. Tax Rates for Long-Term Capital Gains and Qualified Dividends

Under the current law, the maximum individual income tax rate on long-term capital gains and qualified dividends is 15%. The rate is reduced to zero for individual taxpayers in the 10% and 15% income tax brackets. These rates currently sunset after 2010.

The proposal is unchanged from the proposal set forth in the 2010 Green Book of last year and will permanently extend the zero and 15% tax rates for individual taxpayers with income up to $250,000 (for married taxpayers filing jointly) and up to $200,000 (for single taxpayers). For taxpayers exceeding these income thresholds, the tax rate on long-term capital gains and qualified dividends will be 20%. The proposal is effective on the date of enactment for taxable years beginning after 2010.

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We trust this memorandum is helpful in explaining the current tax policies of the Administration. The unanswered question is whether the Administration will have greater success in implementing its tax proposals than its health care proposals. Many believe that the international tax compliance proposals, the carried interest proposals for service partnerships, and the sunset of the 35% maximum tax rate are the provisions most likely to be enacted. However, like the weather in Washington, D.C., anything can happen.