THE RUCHELMAN LAW FIRM

Attorneys at Law

Architects and Designers Building
150 East 58th Street, 14th Floor
New York, New York 10155
Tel. 212-755-3333

Royal Trust Tower, Suite 2401
77 King Street West, PO Box 93
Toronto, Ontario M5K 1G8
Tel. 416 -350-2026

M-E-M-O-R-A-N-D-U-M

To: Clients and Friends

FROM: The Ruchelman Law Firm

RE: Treasury Report on Obama Administration Tax Proposals

DATE: May 19, 2009

We are pleased to provide this overview of key U.S. tax change proposals set forth in the Treasury "General Explanations of the Administration's FY 2010 Revenue Proposals (the "Green Book") which was released on May 11th The proposals in the Green Book are based on various sources including prior Treasury and Joint Committee on Taxation studies, legislative proposals, and proposals of prior Administrations. Certain aspects of the proposals seem clear:

- They are meant to raise significant tax revenue to meet the nation's fiscal crisis and government budget requirements.
- They do not consider taxpayer cost of compliance.
- They intend to fulfill President Obama's campaign pledge of a widespread – but limited – tax cut for virtually all (95%) of U.S. taxpayers including small business, funded primarily with international tax reform and repeal of Bush Administration reductions in individual tax rates.
- They intend to fund the cost of President Obama's planned health care reform proposals with limitations on itemized deductions for high bracket taxpayers, improvement in tax compliance and penalty enforcement and selective tax accounting changes.
- They impose significant record maintenance obligations for all persons participating in an investment in the U.S. and extend the period of limitations that will apply to violations of the record maintenance rules from three years to six years.
- They continue the agoraphobia first evidenced after the September 11, 2001, terrorist attacks on the U.S., but redirect its focus to U.S. persons that are tax cheats recycling funds to the U.S. through offshore banks.

Initial comments recognize the enormity of the issues the Administration has chosen to address, and note technical issues principally involving possible conflicts with international law and treaty obligations of the U.S.

We trust this overview provides insight into the practical aspects of the thought process behind the Administration's proposals.

1. **Extension of Current Policies**

We start with a look at the Green Book Appendix. While that appears to put last first, the Appendix in fact outlines the baseline from which the budget effect of the proposals are evaluated; some of the proposals result in revenue losses for the government while others raise revenue. The Appendix indicates how these will be scored. Consequently, the Appendix sets forth the basic parameters within which the proposals must be viewed.

In principle, Congress addresses tax law changes under a pay-as-you go process. If a tax benefit is added to the law, the reduction of overall tax revenue must be offset by an increase in another area of the Code. Whether this works in practice is beyond the expertise of most people inside Washington and all people outside of Washington.

In Washington, the enactment of a tax benefit is referred to as a "tax expenditure" and the enactment of a tax increase is called a revenue raiser. Two large tax benefits that are expected to sunset in 2009 and 2010 are (i) indexation of inflation-triggers that raise the threshold applicable to alternative minimum tax exposure and (ii) tax cuts adopted in 2001 and 2003. If the former provision is extended beyond its sunset date, the extension would be viewed as major tax expenditures for budget purposes that would have to be offset by a comparable amount of revenue raisers. If the latter provision is not extended, that is not viewed as a revenue raiser because the sunset provision is factored into the budget. For budget purposes, the Administration proposes to treat the expiring provisions as if they would not be scheduled to expire. This has the effect of minimizing the level of the resulting tax expenditure for budget purposes if the alternative minimum tax triggers are extended, thereby minimizing the need for revenue raisers to offset the expenditure. It also has the effect of a revenue raiser as it relates to the elimination of the tax cuts.

In the remainder of this memorandum, we cover the key Green Book provisions, prioritizing them according to our view of relative importance from a substantive tax standpoint.

2. **Upper Income Tax Provisions Dedicated to Deficit Reduction**

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, 2011. 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 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 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 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 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.

3. Reform the U.S. International Tax System

In sum, the proposals to reform the U.S. international tax system could have been worse. The "anti-check-the-box rules" are drafted more narrowly than first thought and the proposals do not take effect until 2011. So while a reexamination of entity classification strategy, foreign source income categorization and funding of U.S. operations will be necessary, there is some time to plan.

a. Anti-Check-the-Box Rules

Under current Treasury regulations, an eligible business entity can elect its classification for Federal tax purposes. An eligible business entity with a single owner may elect to be treated as a corporation or as an entity disregarded as an entity separate from its owner (a "disregarded entity"). An eligible business entity with at least two owners may elect to be treated as a partnership or as a corporation. Certain foreign entities are always treated as corporations for Federal tax purposes (so called "*per se* corporations").

Under the proposal, a foreign eligible entity may be treated as a disregarded entity only if the single owner of the foreign eligible entity is created or organized in the foreign country in which the foreign eligible entity is created or organized. Therefore, a foreign eligible entity with a single owner that is organized or created in a country other than that of its single owner would be treated as a corporation for Federal tax purposes. The proposal would generally not apply to a first-tier foreign eligible entity wholly owned by a United States person. Consequently, U.S. businesses that are pass-though entities for shareholders can themselves own a pass-through entity abroad by making a check-the-box election

The Administration's proposals significantly limit tax planning under the check-the-box rules. Cash mobilization among foreign subsidiaries of U.S. controlled groups could be significantly curtailed. It is interesting to note, however, that the proposal applies only to disregarded entities and not to partnerships. Consequently, it may be possible to mobilize cash via the use of check-the-box partnerships without triggering subpart F income. Of course, the devil is in the details and the U.S. tax treatment of loans from partners to their partnership – and interest paid to partners – will clearly be controlling.

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

b. Deferral of Deductions Related to Deferred Income

Taxpayers generally may deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business. Income tax regulations published by the I.R.S. contain detailed rules regarding allocation and apportionment of expenses for computing the foreign tax credit limitation, viz., the portion of taxable income that is derived from sources outside the U.S.

Under current law, a U.S. person that incurs expenses properly allocable and apportionable 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 only domestic income, viz., it 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. The U.S. person is also permitted to deduct currently other expenses properly allocated or apportioned to the stock of the foreign corporation.

The proposal would defer deductions for expenses (other than research and experimentation expenditures) of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax. The amount of deferred expenses for a particular year would be carried forward to subsequent years and combined with the foreign-source expenses of the U.S. person for such year before determining the impact of the proposal in such year.

The initial view is that this provision is intended to penalize companies that operate abroad through subsidiaries in order to incentivize establishment of active business operations in the U.S. Many believe that this is an employment provision designed to bring back jobs to the U.S. However, business may view this provision as an incentive to move governance and finance operations outside the U.S. to locations where these expenses are fully deductible. That would leave certain general and administrative expenses in the U.S. that would be funded by dividend income. Consequently, it is debatable whether the provision will result in greater employment in the U.S. as illustrated by a provision enacted in the early years of the Clinton Administration. Contending that too much revenue of U.S.-based multinationals was retained outside the U.S. Code §956A was enacted. It was designed to achieve an analogous goal – using the tax law to incentivize the repatriation and tax of what had been permanently deferred earnings of foreign subsidiaries by penalizing excess investment in passive assets of a controlled foreign corporation. Instead, the provision incentivized foreign investment in plant and equipment. It was repealed within two years and the repeal was effective retroactively to the date of enactment.

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

c. Determine the Foreign Credits 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 would be effective for taxable years after December 31, 2010.

d. 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 United States. 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 would be effective for taxable years after December 31, 2010.

e. Outbound Transfers of Intangible Property

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 (or license) of intangible property (as defined in Code §936(h)(3)(B)), the income with respect to such transfer or license must be commensurate with the income attributable to the intangible property. 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.

Controversy often arises concerning the value of intangible property transferred between related persons. 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 would also clarify that in a transfer of multiple intangible properties, the I.R.S. may value the intangible properties on an aggregate basis where that achieves a more reliable result. The proposal would also clarify that intangible property must be valued at its highest and best use, as it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

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

f. Limit Earnings Stripping By Expatriated Entities

Code §163(j) applies to limit the deductibility of certain interest expense paid or accrued by a corporation to related foreign persons and to unrelated domestic persons when loans are guaranteed by related foreign 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, essentially equivalent to EBITDA. It is taxable income computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction. Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year if sufficient limitation exists in that year. In addition, the corporation's excess limitation for a tax year (*i.e.,* the amount by which 50% of adjusted taxable income exceeds net interest expense) may be carried forward to the three 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 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% (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.

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 % of adjusted taxable income with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee. The 50% adjusted taxable income threshold would generally continue 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.

This proposal could severely limit U.S. interest expense deductions of certain high profile entities that have expatriated in prior years.

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

g. Prevent Repatriation Of Earnings In Certain Cross-Border Reorganizations

If as part of an otherwise tax-free 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 (so-called "boot"), Code §356(a)(1) provides that gain will be recognized 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, Code §356(a)(2) provides that, if the exchange has the effect of the distribution of a dividend, all or part of the gain recognized 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 is treated as gain from the exchange of property.

In cross-border reorganizations, the boot-within-gain limitation of current law 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.

The proposal would repeal the boot-within-gain limitation of current law in the case of any reorganization in which the acquiring corporation is foreign and the shareholder's exchange has the effect of the distribution of a dividend, as determined under Code §356(a)(2).

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

i. Prevent The Avoidance Of Dividend Withholding Taxes

A withholding agent generally must withhold a tax of 30% from the gross amount of all U.S.-source fixed or determinable annual or periodical (FDAP) income, profits, or gains of a nonresident, non-citizen individual, foreign corporation, or foreign partnership. In general, dividends paid with respect to the stock of a domestic corporation are U.S.-source dividends. Thus, foreign investors holding stock in domestic corporations are generally subject to 30% 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 United States has entered into a tax treaty.

The source of income from notional principal contracts 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.

Foreign portfolio investors seeking to benefit from the appreciation in value and dividends paid with respect to the stock of a domestic corporation are not limited to holding stock in the corporation. Instead, such an investor can enter into an equity swap. The U.S. tax consequences of these two alternative investments differ significantly. By entering into equity swaps, foreign portfolio investors receive the economic benefit of dividends paid and appreciation in value with respect to U.S. stock without being subject to gross-basis withholding tax.

In order to address the avoidance of U.S. withholding tax through the use of securities lending transactions, the Treasury Department plans to revoke Notice 97-66 and issue guidance that eliminates the benefits of such transactions but minimizes over-withholding. Further, income earned by foreign persons with respect to equity swaps that reference U.S. equities would be treated as U.S.-source to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. An exception to this source rule would apply to swaps with certain characteristics.

The proposal would be effective for taxable years 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 a foreign country. A distinction is drawn between what the foreign country thinks is a tax (a "levy") and what the I.R.S. believes is a creditable foreign income tax. To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under U.S. tax principles. 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 is equal to the amount of the foreign income tax that would otherwise be imposed. 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 income 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 Code §904 foreign tax credit separate category for foreign 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.

The Administration proposes to treat a foreign levy that would otherwise qualify as an income tax as a creditable tax only if the foreign country generally imposes an income tax. To meet this standard, the income tax must be generally applicable to all trades or businesses carried on in that country by its residents or nationals. The proposal generally would retain the rule of present law where the foreign country generally imposes an income tax. However, the safe harbor that applies when a foreign country does not generally impose an income tax would be revised in an unspecified way. 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 that allow a credit for taxes paid or accrued on certain oil

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

4. Combat Under Reporting of Income Through Use of Accounts and Entities in Offshore Jurisdictions

a. Require Greater Reporting by Qualified Intermediaries Regarding U.S. Account Holders

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. 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 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. 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.

Under the Administration's proposal, no foreign financial institution could qualify as a QI unless it identifies all of its account holders that are U.S. persons. A QI would be required to report all reportable payments (thereby treating the QI as a U.S. payor for this purpose) received on behalf of U.S. account holders. As a result, a QI would file Form 1099s with respect to payments to

those U.S. account holders as though the QI were a U.S. financial institution. This proposal authorizes the Treasury Department to issue regulations requiring that for any financial institution to be a QI, commonly-controlled foreign financial institutions must meet certain reporting obligations with respect to account holders or that a financial institution may be a QI only if all commonly-controlled financial institutions are also QIs. In addition, the Treasury Department will be given the authority to provide that for any financial institution to be a QI, it must collect information indicating the beneficial owners of foreign entity account holders and specifically must report any U.S. person that is a beneficial owner. Finally, the proposal would allow the I.R.S. to publish a list of all QIs.

The proposal, would be effective beginning after December 31 of the year of enactment.

b. Require Withholding on Payments of FDAP Income Made Through Nonqualified Intermediaries

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 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.

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 to a nonqualified intermediary would be required to treat the payment as if made to an unknown foreign person and therefore subject to the 30% withholding tax. Under these rules, foreign persons that are subject to excess withholding as a result of this proposal would be permitted to apply for a refund of any excess tax withheld. The effect of this proposal on foreign entities treated as partnerships would be severe. Unless the foreign partnership agrees to be a reporting partnership, it would seem to be caught up in the proposal.

This proposal, which is effective for payments made after December 31 of the year of enactment.

c. Require Withholding on Gross Proceeds Paid to Certain Nonqualified Intermediaries

Under current law, 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. While a withholding agent generally must withhold tax at a rate of 30% from the gross amount of FDAP income of a nonresident, non-citizen individual or foreign entity, FDAP income generally does not include gross proceeds or gains from sales.

Under the Administration's proposal, a withholding agent would be required to withhold tax at a rate of 20% on gross proceeds from the sale of any security of a type that would be reported to a U.S. non-exempt payee, when paid by the withholding agent to a nonqualified intermediary that is located in a jurisdiction with which the United States does not have a comprehensive income tax treaty that includes a satisfactory exchange of information program. In the case of excess withholding, nonqualified intermediaries would be eligible to claim a refund on behalf of their direct account holders for any taxable year in which they identified all of their direct account holders that are U.S. persons and reported all reportable payments received on behalf of U.S. account holders. Moreover, foreign persons that are subject to withholding tax in excess of their income tax liability as a result of this proposal, and on whose behalf a refund claim is not made by a nonqualified intermediary, would be permitted to apply for a refund of any tax withheld.

This proposal, effective for payments made after December 31 of the year of enactment.

d. Require Reporting of Certain Transfers of Money or Property to Foreign Financial Accounts

Under current law, a United States 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 United States 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, or by any entity of which the individual owns, actually or constructively, more than 50% of the ownership interest. Transfers to accounts held at qualified intermediaries and receipts from accounts held by U.S. persons at qualified intermediaries would not be required to be reported. In

addition, individuals would be exempt from reporting 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 $10,000. Failure to report a covered transfer would result in 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 unless the taxpayer's failure to report was due to reasonable cause. The Treasury Department would receive regulatory authority to issue anti-abuse rules and to provide exceptions to the reporting requirement, such as an exception for arm's-length payments in the ordinary course of business for services or tangible property.

This proposal, effective for transfers made after December 31 of the year of enactment.

e. Require Disclosure of FBAR Accounts to be Filed with Tax Return

Under current law, the ownership of or signatory authority over a foreign financial account is made on a form that is not part of the tax return, Form TD F 90.22.1 (FBAR). 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 individual taxpayers, who are required to file an FBAR, to disclose certain information on their income tax returns. This information would be disclosed on a schedule that would be considered part of the individual's income tax return. The schedule would be consistent with the information disclosure obligations of the FBAR itself. While the FBAR is not required to be filed until June 30 after the taxpayer's calendar year, the information return would be due when the income tax return is due, and would not replace or mitigate the individual's obligation to separately file an FBAR with the Treasury Department. Once enacted, this will impair a person's ability to maintain confidentiality by placing assets with overseas institutions. In a law suit tax returns are typically sought by claimants. Consequently, claimants' legal counsel in civil litigation will be given a full picture of the financial posture of the defendant.

This proposal would be effective for taxable years beginning after December 31 of the year of enactment.

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

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.

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 intermediary and any qualified intermediary that transfers (or receives) money or property with a value of more than $10,000 to a foreign bank, brokerage, or other financial account on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50% of the ownership interest) would be

required to file an information return regarding such transfer (or receipt). In addition, any U.S. financial intermediary and any QI that opens a foreign bank, brokerage, or other financial account on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50% of the ownership interest) would be required to file an information return regarding such account. Exceptions to the reporting requirement would be provided for (1) accounts opened and amounts transferred to, from, or on behalf of, publicly traded companies and their subsidiaries, (2) accounts opened at and transfers made to QIs on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50% of the ownership interest); or (3) transfers received by or on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50% of the ownership interest) from accounts held by a U.S. person at a qualified intermediary.

This proposal, effective for amounts transferred and accounts opened beginning after December 31 of the year of enactment.

g. Require Third-Party Information Reporting Regarding the Establishment of Offshore Entities

Under current law, a United States person generally must report certain information with respect to certain foreign business entities that they control. However, current law does not generally require third-party information reporting in connection with the acquisition or formation of a foreign business entity on behalf of a U.S. individual. In addition, current law does not require withholding agents to ascertain the ownership of foreign payees that may be entities with respect to which U.S. persons have a U.S. reporting or income tax obligation.

Under this proposal, any U.S. person or any QI, that forms or acquires a foreign entity on behalf of a U.S. individual (or on behalf of any entity of which the individual owns, actually or constructively, more than 50% of the ownership interest) would be required to file an information return with the I.R.S. regarding the foreign entity that is formed or acquired.

This proposal, effective for entities formed or acquired after December 31 of the year of enactment.

h. Negative Presumption for Foreign Accounts with Respect to Which an FBAR Has Not Been Filed

Under current law, the civil penalty for failing to disclose a foreign financial account on an FBAR does not exceed $10,000 absent a willful violation, and may not be imposed if the violation was due to reasonable cause and the balance in the account was properly reported. In the case of a willful violation, the maximum civil penalty is the greater of $100,000 or 50% of the balance in the account at the time of the violation. In addition, criminal penalties for willfully failing to report a foreign bank account include a maximum fine of $250,000, a maximum term of imprisonment of five years, or both, with higher penalties if the defendant violates any other U.S. law, or if the violation was part of a pattern of any illegal activity involving more than $100,000 in a 12-month period.

The Administration proposes the adoption of a rebuttable evidentiary presumption would be applicable in a civil administrative or judicial proceeding (but not in a criminal proceeding) under which any foreign financial account in which a U.S. person (or a foreign person in and doing business in the U.S.) has a financial interest in or signatory authority over will be presumed to contain enough funds to require the riling of an FBAR. An exception would apply for accounts held through a qualified intermediary.

The proposal would be effective for FBARs due to be filed beginning after the date of enactment.

i. Negative Presumption Regarding Failure to File an FBAR for Accounts with Nonqualified Intermediaries

Concerned that U.S. persons are failing to comply with FBAR filing obligations, the Administration proposes adoption of a second rebuttable evidentiary presumption in civil administrative or judicial proceedings under which the failure to file an FBAR for a foreign financial account held with a nonqualified intermediary will be deemed to be willful if the account has a balance of more than $200,000 at any point during the calendar year. The evidentiary presumption would not apply to accounts in which the person has signature or other authority by virtue of being an officer or employee of a corporation, but otherwise has no more than a de minimis financial interest in that corporation. The Treasury Department would receive regulatory authority to provide exceptions to the presumption.

The proposal would be effective for FBARs due to be filed beginning after the date of enactment.

j. Negative Presumption Regarding Withholding on FDAP Payments to Certain Foreign Entities

Under current law, payments of U.S.-source FDAP income to nonresident, non-citizen individuals and foreign entities are subject to 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 the recipient of a payment is exempt from withholding tax or eligible for a reduced rate of withholding tax, withholding agents generally must rely on beneficial ownership documentation provided by the payee certifying that the payee is entitled to such an exemption from withholding tax or a reduced rate of withholding tax. Absent actual knowledge or a reason to know that the information provided by the payee is incorrect or unreliable, withholding agents are entitled to rely on the self-certification that they receive from the payee. 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. In certain circumstances, payees who are not entitled to an exemption from withholding tax or a reduced rate of withholding tax may arrange to receive payments through entities that make it appear as if the payee is qualified for such beneficial treatment.

Under the Administration's proposal, any withholding agent making a payment of FDAP income to a foreign entity would be required to treat the payment as if it were made to an unknown person (and thus, subject to the 30% withholding tax), unless the foreign entity provides documentation of the entity's beneficial owners. There would be exceptions to the rule provided for publicly traded companies and their subsidiaries, foreign governments, and pension funds. The Treasury Department would also have regulatory authority to provide additional exceptions for payments to entities engaged in the active conduct of a trade or business in their country of residence, charities, widely-held investment vehicles, entities that enter into an agreement with the I.R.S. to collect documentation for all owners and report all U.S. non-exempt owners to the I.R.S., and for any other payment that the Treasury Department determines presents a low risk of tax evasion.

In essence, this provision expands the "know-your-customer" rules applicable to financial institutions to the tax law. All U.S. entities that wish to collect foreign person withholding tax at a reduced rate by treaty will have to maintain a paper trail between the ultimate beneficial owners and the entity itself and that trail will be required to be updated as of each payment date. Special purpose vehicles formed as part of a tax planning strategy are the likely targets of this provision.

This proposal would be effective for payments made after December 31 of the year of enactment.

k. Extend Statute of Limitations for Certain Reportable Cross-Border Transactions and Foreign Entities

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).

Believing that the generally applicable three-year statute of limitations does not always allow sufficient time for the I.R.S. to determine a taxpayer's tax liability if a violation of record maintenance obligations under Code §6038A has occurred, the Administration proposes to extend the three-year period for assessing tax to six years. In addition, the information returns with respect to which Code §6501(c)(8) applies would be broadened to include (i) the information returns filed by qualifying electing funds pursuant to regulations under Code §1295(b), (ii) the proposed tax return disclosure of FBAR information, and (iii) the information returns proposed to be required of U.S. individuals with respect to transfers of money or property

to and receipts from foreign financial accounts. The extended statute of limitations would also apply in the case of failure to furnish information or maintain records as required by Code §6038A(a). Moreover, the Code §6501(c)(8) exception to the general statute of limitations would be made applicable to the entire income tax return.

This proposal would be effective for returns due to be filed after the date of enactment.

l. Double Accuracy-Related Penalties on Understatements Involving Undisclosed Foreign Accounts

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 an effort to discourage United States 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% when the understatement arises from a transaction involving a foreign account that the taxpayer failed to disclose properly under the proposed requirement that taxpayers disclose FBAR-related information on their income tax returns. In addition, in the case of a reportable transaction understatement, the reasonable cause exception would not be available with respect to this increased penalty.

This proposal would be effective for taxable years beginning after December 31 of the year of enactment.

m. Improve the Foreign Trust Reporting Penalty

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 United States 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 continued failure to report. 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.

This proposal would be effective for information reports required to be filed after December 31, of the year of enactment.

n. Require Information Reporting for Rental Property Expense Payments

Under current law, a taxpayer making payments in the course of a trade or business to a noncorporate recipient aggregating to $600 or more for services or determinable gains in a calendar is required to send an information return to the I.R.S. setting forth the amount, as well as name and address of the recipient of the payment (generally on Form 1099). If the taxpayer making the payment is not engaged in a trade or business, such information reporting is not required.

At present, there is limited third-party information reporting related to rental real estate expenses because only taxpayers whose rental real estate activity is considered a trade or business are required to report payments, and such a determination as to whether a rental activity is a trade or business is usually made on a case-by-case basis.

Under the assumption that increased third-party reporting of major rental expenses is likely to improve reporting compliance on rental real estate income, the Administration has proposed to subject recipients of rental income from real estate to the same reporting requirements as are taxpayers engaged in a trade or business. Thus, rental income recipients making payments of $600 or more to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income would be required to send an information return, generally a Form 1099-MISC, to the I.R.S. and to the service provider. There will be exceptions to the reporting requirement in particularly burdensome situations, such as for taxpayers (including members of the military) who rent their principal residence on a temporary basis, or for those who receive only small amounts of rental income.

The proposal would be effective for tax years beginning after December 31, 2009.

5. Levy Tax on Certain Offshore Oil and Gas Production

There is currently no Federal tax imposed on the production of oil and gas on the Outer Continental Shelf ("OCS"). According to the Government Accounting Office, the return to the taxpayer from OCS production is among the lowest in the world. Such a tax on OCS production would raise the return to the taxpayer and encourage sustainable domestic oil and gas production.

The Administration is developing a proposal to impose an excise tax on certain oil and gas produced offshore in the future, and will work with Congress to develop the details of this proposal.

6. Strengthening Tax Administration

The office of the Treasury Inspector General for Tax Administration ("TIGTA") was established under the relevant provisions of The I.R.S. Restructuring and Reform Act of 1998. Its mission is to audit I.R.S. administrative activities with a view to improving efficiencies and related results in all areas of tax administration. As illustrated in TIGTA's semi-annual report for the period April 1, 2008 to September 30, 2008, critical areas of tax administration are (i) modernization of information gathering systems and procedures, (ii) improvement of tax compliance and collection, and (iii) tightening of enforcement procedures. Measurement of success in these areas has focused on annual review of business modernization systems, percentage of filed tax returns examined, and increased acceptance of I.R.S. Criminal Investigation Division cases by the Department of Justice.

The tax administration proposals are consistent with and reflect TIGTA reports and commentary with respect to current I.R.S. administration of the tax laws.

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 would be effective after December 31, 2010.

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 first 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 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 would be for offers-in-compromise submitted after the date of 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 would be effective for returns required to be filed after December 31, 2009.

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 would be effective for disclosures made after enactment.

f. Extension Of Statute Of Limitations Where State Tax Adjustment Affects Federal Tax Liability

In general, the I.R.S. is prevented from assessing additional Federal tax liabilities once the statute of limitations runs with regard to the year. 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. State and local authorities employ a variety of statutes of limitations for State and local tax assessments. The Administration proposes to create an exception to the general three-year statute of limitations for assessment of Federal tax resulting from adjustments to State or local tax liability. The statute of limitations would be extended the greater of (i) one year from the date the taxpayer first files an amended tax return with the I.R.S. reflecting adjustments to the State or local tax return or (2) two years from the date the I.R.S.

first receives information from the State or local revenue agency under an information sharing agreement in place between the I.R.S. 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 proposal would be effective for returns required to be filed after December 31, 2009.

g. Investigative Disclosure

In the course of an examination, the I.R.S. is empowered to obtain information regarding a taxpayer from unrelated persons. A thorny issue has arisen over whether the mere contact of an unrelated person by the I.R.S. is a disclosure that the subject taxpayer is under I.R.S. examination that is allowed under the taxpayer privacy provisions. The Administration proposes to eliminate the problem by expressly allowing I.R.S. examiners to contact third parties without that contact being considered a violation of taxpayer privacy rights.

The proposal would be effective for disclosure made after enactment.

h. 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 would be effective for tax returns required to be filed after December 31, 2010.

i. Bad Check Penalty

Believe it or not, some taxpayers issue bad checks to the I.R.S. Current law penalizes taxpayers who issue bad money orders or bank checks. The penalty is 2% of the 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 would be effective for returns required to be filed after December 31, 2009.

j. 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 would be effective for returns required to be electronically filed after December 31, 2010.

7. Estate and Gift Taxation Reform

Key Estate and Gift tax proposals prepare for the permanent status of the estate and gift tax regime. Key taxpayer/I.R.S. issues have recently revolved around valuation techniques employed in estate tax planning in general and specifically with respect to transfers in family owned companies.

a. Consistency In Value For Estate and Income Tax Purposes

In order 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 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 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).

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

8. Tax Cuts for Business

a. Eliminate Capital Gains Taxation on Investments in Small Business Stock

It was noted that the current exclusions of capital gains for sales of qualifying small business stock were not beneficial enough due to a residual capital gains tax and inclusion in the alternative minimum tax base. Accordingly, the proposal is to exempt all gain from the sale of this stock from capital gains and eliminate the alternative minimum tax preference item. The current rules regarding holding periods, qualifying stock, etc. remain the same and there would be increased documentation requirements.

This proposal would be effective for small business stock issued after February 17, 2009.

b. Make the Research and Experimentation (R&E) Tax Credit Permanent

One of the most publicized proposals to encourage continued R&E and related business expansion activity in the U.S. has been the proposal to make permanent the R&E tax credit. The credit is currently scheduled to expire at the end of 2009 but would be made permanent. Existing calculation mechanics, substantive rules, and presumably I.R.S. scrutiny, would remain.

c. Expand the NOL Carryback

There is no substantive proposal here, but it is worth noting that the Administration supports an expanded NOL carryback in the hopes that tax refunds generated by the carrybacks would be used for new capital expenditures and other business expansion activities.

d. Continuation of Expiring Tax Provisions Through 2010

Certain taxpayer-favorable provisions would be extended another year in the interests of providing taxpayers some certainty with which to plan their affairs. Include in the list of extenders through December 31, 2010 are:

i. The optional deduction for state and local general sales tax;

ii. Subpart F active financing and look-through exceptions;

iii. Exclusion from unrelated business income of certain payments to controlling exempt organizations;

iv. The new markets tax credit;

v. The modified recovery period for qualified leasehold improvements and qualified restaurant property;

vi. Incentives for empowerment and community renewal zones;

vii. Credits for bio-diesel and renewable diesel fuels; and

viii. Several trade agreements including the Generalized System of Preference and the Caribbean Basin Initiative.

9. Other Revenue Changes and Loophole Closures

These proposals are specific to perceived abuses and could be viewed to be political in nature.

a. Tax on Carried (Profits) Interests as Ordinary Income

Current partnership tax law allows for a partner to obtain a partnership interest in return for services to be performed for the partnership. This allows capital and labor to join in carrying on the business of the venture. In general, the receipt of a profits interest could be viewed to be a taxable event if the profits interest is viewed as valuable property. This would not be so if the anticipated profit is not a "sure thing." As a result, the receipt of a profits interest in return for services is not considered a taxable transaction where certain conditions exist suggesting that the value of the interest itself is nil. Once the person providing the labor is a partner, that person is taxed at favorable rates on his or her distributive share of partnership gains.

These rules apply whether a partnership operates real property or invests in other businesses as a hedge fund or private equity fund. A fund manager typically was under-compensated with salary, looking principally for a share of the fund's long term capital gains as his or her principal reward

There is a widely held belief in the U.S. that private equity fund and hedge fund managers played a significant role in the collapse of the financial markets and the current economic crisis. This view is especially popular with out-of-work factory workers.

Whether or not the view is justified, these people are targets of the Administration's tax policy. The Administration proposes that income from a "Service Partner Interest" ("SPI") would be considered ordinary income regardless of the character of the income to the partnership. A SPI

is defined as a carried interest of an individual who provides services to the partnership. SPI treatment would not apply to the extent capital is contributed to the partnership by the partner. Capital is defined in terms of money or capital, not loans or advances. A partnership interest could be a "disqualified interest" to the extent it is based on convertible or contingent debt, an option, or a derivative with respect to the entity itself. In that case, gain from the sale of such interest by an individual performing services for the partnership will also be considered ordinary income.

This provision has raised concern from the American Bar Association and the Center for Capital Markets as having a possible "chilling effect" on bona-fide business arrangements other than the hedge fund managers' situations. It is a provision that is drafted to attack a specific industry but uses language that is far broader than the targeted group.

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

b. Codify "Economic Substance" Doctrine

This provision has been scored as a relatively modest revenue raiser ($4.7 Billion over the 2010-2019 score-keeping period). However it has the potential to be a far-reaching tax provision.

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 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.

c. Repeal of Last-in First-out ("LIFO") method of accounting for inventories.

The Administration proposes to repeal the LIFO inventory accounting method. The reasons given for a proposal designed to raise $61 billion in added tax revenue are (i) book/tax accounting conformity due to the adoption of international accounting standards which do not recognize LIFO, (ii) correction of an unfair advantage to those enterprises facing increased costs of inventory, and (iii) a desire to eliminate costly and complex LIFO calculations.

This proposal would be effective for the first taxable year beginning after December 31, 2011 at which point taxpayers would be required to write up (presumably) their inventory from the amount determined under LIFO to the amount determined under the First-in First out ("FIFO" method. The adjustment would be taken into account ratably over the following seven years.

d. Repeal Lower of Cost or Market Inventory Accounting Method

The Lower of Cost or Market ("LCM") method of inventory accounting is currently an alternative method to LIFO or FIFO. The LCM method essentially provides a mark-to-market write-down of inventory from cost to fair market value. The Administration maintains the view that the resulting increase in cost-of-sales is considered an unwarranted reflection of an expense prior to realization. A related concern is expressed with respect to the retail method of inventory of accounting, used by retailers to reflect anticipate write-downs of inventory. Consequently, it proposes to repeal the LCM method of inventory accounting for reasons similar to the proposed repeal of LIFO.

The proposal is effective for taxable years beginning 12 months after enactment.

10. Financial Institutions and Products

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

A corporation is not taxable on proceeds from the sale of its own stock other than the realization of interest income where the purchaser's payment for the stock is deferred. In comparison, if a corporation makes a forward sale of its stock, no interest element is present. The Administration proposes to treat a forward sale of the stock in the same manner as a deferred payment sale.

This proposal is effective for forward contracts entered into after December 31, 2010.

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.

This proposal is effective after the date of enactment, maybe not soon enough for some dealers.

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 section to include a parent-subsidiary group (Code §1563(a)(1)) where indirect control may exist.

* * * * *

Regardless of politics, it is clear that the U.S. government needs new sources of revenue to carry out its programs and to pay for various aspects of the bail-out and health care reform. The Administration's proposals acknowledge that need by proposing rules that will raise tax by (i) changing the rules under which income is categorized or measured, (ii) eliminating tax planning opportunities that have existed for many years, and (iii) imposing information reporting obligations at unprecedented levels in taxation. Those who have income or wealth should be prepared to share with their fellow citizens.