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Planning Perspective

Administration Outlines Fiscal 2011 Tax Proposals

By Kevin Anderson and Larry Cohen (BDO Seidman, LLP)

Summary

On February 1, 2010, the Treasury Department released General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (Green Book), which provides a description of the Obama Administration's budget proposals affecting revenues. These proposals are an outline of the Administration's policy initiatives, and will serve as the blueprint for future discussions with Congress. The legislative process may take significant time as the proposed changes affect a multitude of Internal Revenue Code provisions, and members of Congress may not support the precise proposals made by the Administration. Thus, whether these proposals are ultimately enacted into law, how they may be modified, and when they will be effective, cannot be known.

Set forth below is a summary of many of the proposed changes affecting domestic taxation, or general administrative provisions.

A significant underlying premise of the Green Book is that most of the tax cuts enacted early in the last decade, which are scheduled to expire on December 31, 2010, will be extended, except as noted.

General Provisions

• *Extend Certain Expiring Provisions through Calendar Year 2011.* Certain expiring provisions, including the optional deduction for state and local sales taxes, the modified recovery period for qualified leasehold improvements and qualified restaurant property, the exclusion from unrelated business income of certain payments to controlling exempt organizations, incentives for empowerment and community renewal zones, and several trade agreements, would be extended through December 31, 2011.

• *Codify the "Economic Substance" Doctrine.* The common-law "economic substance" doctrine generally denies tax benefits from a transaction that does not meaningfully change a taxpayer's economic position, other than tax consequences, even if the transaction literally satisfies the requirements of the Internal Revenue Code. Although courts have applied the economic substance doctrine with increasing frequency, they have not applied it uniformly. The proposal would provide that a transaction satisfies the economic substance doctrine only if *(i)* it changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position, and *(ii)* the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. The proposal would also clarify that a transaction will not be treated as having economic substance solely by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction. In addition, the proposal would impose a 30-percent penalty on an understatement of tax attributable to a transaction that lacks economic substance, reduced to 20 percent if there was adequate disclosure of the relevant facts in the taxpayer's return. The proposed penalty would be imposed with regard to an understatement due to a transaction's lack of economic substance in lieu of other accuracy-related penalties. Finally, the proposal would deny a deduction for interest attributable to an understatement of tax arising from the application of the economic substance doctrine. The proposal would apply to transactions entered into after the date of enactment. The proposed denial of interest deductions would be effective for taxable years ending after the date of enactment with respect to transactions entered into after such date.

The proposal would make the R&E tax credit permanent.

Business Tax Provisions

• *Permanently Extend the Research and Experimentation (R&E) Tax Credit.* Under current law, the R&E tax credit expired on December 31, 2009. The R&E tax credit is 20 percent of qualified research expenses above a base amount. The base amount is the product of the taxpayer's average gross receipts for the four preceding years and the ratio of its research expenses to gross receipts for the 1984-88 period. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year. Taxpayers can elect the alternative simplified research

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IRS Wants a Roadmap: Proposes Broad Disclosure of Uncertain Tax Positions on Returns and Guts Restraint Policy on Tax Accrual Workpapers

By William F. Colgin Jr., Barton W.S. Bassett and Gary B. Wilcox (Morgan, Lewis & Bockius LLP)

On January 26, the Internal Revenue Service (IRS) announced its intention to require corporate taxpayers to disclose all uncertain tax positions on a new schedule to be attached to the yearly tax return. Under the current proposal, corporate taxpayers would be required to state the maximum amounts of potential tax liabilities as well. Announcement 2010-9 (Announcement) sets forth the proposal and requests comments by March 29, 2010. The Announcement describes, but does not attach, a proposed schedule to be added to Form 1120 and other unspecified business tax returns.[1]

The Announcement indicates that the IRS intends the schedule to be filed by business taxpayers with total assets in excess of $10 million. The requirement would extend to a taxpayer that prepares financial statements, or that is included in the financial statements of a related entity that prepares financial statements, if such taxpayer or related entity determines its U.S. federal income tax reserves under FIN 48[2] or other accounting standards[3] relating to uncertain tax positions involving U.S. federal income tax. The IRS does not define the term "uncertain tax positions," but the Announcement provides instances where the requirements would apply even though no tax reserve exists, as discussed below. Thus, the IRS requirements go beyond FIN 48 or other reserve requirements.

The proposal is prospective in application, and would apply to all tax returns filed after the date the schedule is released in final. The Announcement indicates the IRS intends to finalize the new schedule "as quickly as possible" and requests comments to be submitted by March 29, 2010. While a due date on April 1st might be more appropriate, this timing indicates the IRS is serious about proceeding with this schedule on an expedited basis.

Maximum Amounts for Each Issue to be Disclosed

Taxpayers would be required to state on the new schedule "the maximum amount of potential federal tax liability attributable to each uncertain tax position." Thus, even though the amount of a potential tax liability recorded in a reserve is less than the maximum amount due to risk adjustments under financial accounting rules, the IRS is requiring that taxpayers report the full potential liability without regard to a risk adjustment.[4]

There is no materiality requirement. The Announcement broadly states that the schedule to Form 1120 will require a description of each uncertain tax position "for which the taxpayer or a related entity has recorded a reserve in its financial statements." Literally, this language suggests that even if a very small reserve is recorded for a given tax position (for example, 10 percent), the tax position must be described on the schedule.

The IRS requirements go beyond FIN 48 or other reserve requirements.

Valuing such maximum potential exposures is inherently problematic in various areas of the law and will certainly produce inconsistent results. For example, what is the maximum amount of potential federal tax liability that should be ascribed to a marketing intangible for a potential IRS adjustment under section 482? Anyone familiar with transfer pricing disputes under section 482 is well versed in the wide variances that can occur between the IRS and taxpayers with respect to income attributable to intangible property. For a recent example of such divergence of opinion, see *Veritas v. Commissioner*, 133 T.C. No. 14 (December 10, 2009) (in which the IRS issued a notice of deficiency asserting a $2.5 billion adjustment to the taxpayer's buy-in amount in an IRC section 482 cost-sharing structure).

Some Tax Positions that are Not Reserved Must Still be Disclosed

The Announcement states that certain tax positions that are not reserved must still be disclosed on the schedule, if the reason for not recording a reserve is "because *(i)* the taxpayer expects to litigate the position, or *(ii)* the taxpayer has determined that the Service has a general administrative

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Green for Green: Federal and State Tax Breaks for Renewable Energy Projects

By Jane C. Luxton, Todd B. Reinstein and William J. Walsh (Pepper Hamilton LLP)

On January 8, 2010, President Obama announced the award of $2.3 billion in tax credits for clean energy manufacturing operations in 43 states, from funds allocated under the 2009 stimulus package.[1] The previous month, the U.S. House of Representatives included a provision in the Jobs Bill it passed on December 16, 2009, that provides $2 billion in funding to restore money to the Department of Energy's (DOE) loan guarantee program for renewable energy that was diverted to pay for the "cash for clunkers" initiative last summer.[2] The Senate will take up the bill early in 2010, and some clean-energy advocates in Congress and elsewhere are urging that more funds be appropriated for renewable energy incentives.

Make no mistake: the U.S. Government is working hard to promote renewable energy development and doing so in the most meaningful way possible—with loan guarantee programs, grants, and tax breaks. Many states have adopted additional economic measures that incentivize in-state renewable energy projects. But the hodgepodge nature of these programs—authorized by different pieces of legislation, administered under an array of regulatory regimes, subject to varying requirements and deadlines—presents a serious challenge to interested parties seeking financial assistance for renewables projects.

This article summarizes the main categories of economic incentives available for renewable energy development, along with key information about eligibility and availability.[3] The four types of programs are: (1) U.S. Department of Energy loan guarantees; (2) federal tax incentives; (3) other federal government economic incentive programs; and (4) state programs.

DOE Loan Guarantees

DOE administers two large-scale loan guarantee programs for clean energy generation and manufacture, which fall under Sections 1703 and 1705 of the Energy Policy Act of 2005 (EPAct), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA).[4] Major aspects of these programs are presented in Table 1.[5]

Federal Tax Incentives

As with the DOE loan guarantee programs, the 2009 stimulus package expanded existing renewable energy tax incentives and added new ones. The three principal programs are Sections 45 and 48 of the Internal Revenue Code of 1986[6] and Section 1603 of ARRA.

Section 45 provides a production tax credit (PTC) for the production and sale of renewable energy to an unrelated taxpayer. With changes made under ARRA, the credit extends over a ten-year period and currently ranges from 1 cent to 2.1 cents per kilowatt (KW), depending on the type of power (these rates are adjusted annually for inflation). Facilities must be qualified (as defined in the statute). The modifications added under ARRA have expanded the range of structuring and tax allocation arrangements that are permissible.[7] For example, taxpayers with qualifying facilities under Section 45 may temporarily receive an investment tax credit under Section 48 in lieu of the Section 45 credit. In certain circumstances the immediacy of the investment tax credit may be more beneficial than receiving the variable credit over ten years under the Section 45 provisions.

The federal government is promoting renewable energy development through loan guarantee programs, grants, and tax breaks.

Section 48 makes available an investment tax credit (ITC) for equipment that uses certain renewable energy sources to generate electricity or heating or cooling. Eligible sources include solar, small wind (less than 100 KW), fuel cells, geothermal, microturbines, and heat pumps, with tax credits ranging from 10 to 30 percent. The tax credit is designed with some flexibility permitted; for example, it may be allocated within sale-leaseback arrangements, but there are limitations and considerations that require careful planning to maximize tax savings. Most applications of the Section 48 credit expire at the end of 2016.

In addition to the regular provisions of Section 48,

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Table 1

Program	**Key Elements**	**Eligibility**	**Other**
1703 Loan guarantees for early commercial use of innovative clean energy technologies. Aggregate funding for 1703 and 1705 of $100 billion.	Permanent program under Energy Policy Act of 2005.	Biomass, geothermal, hydropower, solar, wave/tidal, wind (also carbon capture and sequestration, coal gasification, nuclear, fuel, vehicles, and energy transmission systems). Projects must avoid, reduce, or sequester air pollutants or greenhouse gases, using significantly improved technologies compared to commercially available methods.	Funding depends on annual Congressional appropriations. Priority given to loans of $25 million or more. Borrower must pay cost of loan guarantee.
1705 Loan guarantees for renewable energy systems and facilities that manufacture components for renewable energy. Aggregate funding for 1703 and 1705 of $100 billion; target for 1705 program is $4 billion to cover credit subsidy costs ($6 billion if cash-for-clunkers funding is restored).	Temporary program added to EPAct by ARRA. Application must conform to Financial Institution Partnership Program (FIPP).	Biomass, geothermal, hydropower, solar, wave/tidal, wind (also energy transmission systems). Focus is on commercially available technologies. Applicants must be commercial, non-profit, or public financial institutions, partnering with project developers. First solicitation released Oct. 2009 for energy generation projects; manufacturing solicitation expected in early 2010. Applications considered on rolling basis, with a cutoff for Part I application of Aug. 24, 2010. Projects must comply with Davis-Bacon and NEPA. NEPA considerations disfavor more complex sites that would require an environmental impact statement (EIS) as opposed to a simpler environmental assessment (EA), given the September 30, 2011 construction start deadline.	Authority for program expires Sept. 30, 2011. All approved projects must begin construction by Sept. 30, 2011. Minimum 20 percent equity requirement (may include funds from grants and tax credits, but caution is advised in relying on these in an application). Up to 80 percent of senior loan amount (64 percent of total project costs) may be guaranteed by DOE. Bank must retain 20 percent of the loan amount ("skin in the game"). Application fees are $50,000 ($12,500 for Part I) and nonrefundable.

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ARRA added a new section 48C, allowing an ITC of 30 percent for qualified tangible personal property placed in service at manufacturing facilities for "qualified advanced energy projects." Qualifying projects are those that re-equip, expand, or establish a manufacturing facility for the production of renewable energy; fuel cells and related capabilities for electric or hybrid-electric vehicles; renewable energy electrical grids; carbon capture and sequestration; energy conservation, including renewable fuels and lighting technologies; and "other advanced energy property designed to reduce greenhouse gas as designated by the Secretary of Treasury." In August, the Treasury Department released guidance for this program, including useful definitions, in Notice 2009-72.[8] Importantly, to qualify for the initial round of this tax credit, taxpayers must have submitted an application to DOE and the Internal Revenue Service (IRS) by Oct. 16, 2009. As noted at the beginning of this article, awards were announced Jan. 8, 2010, totaling the entire $2.3 billion originally allocated under the program. Future award rounds may be established if Congress appropriates additional funds.

Section 1603 of ARRA authorizes the Treasury Department to pay grants in lieu of tax credits for specified renewable energy property. The payments are available for solar, wind, geothermal, and other renewable energy investments placed in service in 2009 or 2010 that would qualify for a tax credit under Sections 45 or 48, discussed above. On July 9, 2009, Treasury and DOE announced guidance for the program, which sets forth application procedures and clarifies eligibility requirements.[9] To date, the Treasury has disbursed almost $2 billion under this program.

Other Federal Government Programs

Additional federal programs tend to be specialized, and often are focused on assistance to university and other scientific researchers. For example, DOE has a grant program administered by its Advanced Research and Projects Agency (ARPA) that has been active in the areas of biofuels, wind, and solar technologies, as well as hybrid vehicles and their power sources. One of these initiatives targeted transformational energy technologies ready for commercialization. Other ARRA-funded grants totaling

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$32.7 billion have been awarded for state and private-sector projects across a spectrum of technologies and applications.[10] However, these programs are not currently in a position to accept applications unless new funding is made available or the application process is reopened, because money remains undistributed after the first round of announced grants.[11]

Other federal programs include the U.S. Department of Agriculture's Rural Energy for America Program (REAP), which provides grants to agricultural producers and rural small businesses for renewable energy systems and energy efficiency improvements. Eligible projects include those that produce energy from wind, solar, biomass, geothermal, hydropower, and hydrogen-based sources. Funding is available through 2012.[12]

State Programs

State incentives for renewable energy vary considerably. New Jersey and California have been in the vanguard of efforts to promote renewable energy, using grants, tax breaks, and credible measures that encourage utilities to buy renewable energy generated by others. Typically states motivate the utilities by specifying a percentage of their energy output that must come from renewable sources, either produced by the utility or purchased from others (a renewable energy portfolio standard).[13] Currently 29 states have mandatory programs, which can generate marketable credits. Up to 30 percent of the funding for some renewables projects, particularly in the area of solar cells, comes from the sale of these credits to utilities. As the number of states with renewables portfolio programs continues to change, this is an area that warrants careful attention.[14]

While many states offer incentives for residences,

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Table 2

State[16]	Tax Credit	Grant/Rebate	Loan	Utilities Portfolio Standard (amounts and criteria vary widely)
CA	Yes (solar only)	Yes	No	Yes, 20 percent by 2010, 33 percent by 2020, no credit trading (under discussion)
IL	Yes	Yes	No	Yes, 25 percent by 2025, credit trading allowed
MI	Yes	Some grants available, plus rebates	No	Yes, 10 percent by 2015, credit trading allowed
NV	Yes	Yes	No	Yes, 25 percent by 2025, credit trading allowed
NJ	Yes	Yes, including rebates in the form of tradeable solar renewable energy certificates	Yes	Yes, 22.5 percent by 2021, credit trading allowed
NY	Yes (green buildings only)	Yes	No, closed	Yes, 29 percent by 2015, no credit trading
PA	Yes (wind only)	Yes	Yes	Yes, 18 percent by 2021, credit trading allowed

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schools, and public hospitals, and in the area of hybrid vehicles and alternative fuel, Table 2 gives a quick sample of the status of programs available to industry and commercial operations in a representative collection of states.[15] The richness of the programs available and the renewable technologies to which they apply differ significantly across states, making it important to look closely at individual state incentives programs.

Financing Strategies

As a practical matter, given the continued lethargy in capital markets, project developers may need to combine public and private financing in increasingly creative ways. Thus, project designers should consider the following approaches.

First, interested parties should systematically evaluate available funding opportunities and how they may fit into project planning. Programs differ significantly in criteria, scope, and timing. If the project has site flexibility, there may be clear advantages in selecting one state over another, particularly in light of varying renewable energy portfolio requirements and differing incentives for particular types of renewable energy.

Second, applications for funding need to meld a clear, technically-solid description of the technology with an explanation of how it satisfies the policy preferences embedded in the incentive program, as well as the requirements that apply to the specific grant or loan solicitation. For example, U.S. ownership is not a prerequisite, as long as the operation is in the United States. Funding opportunities under ARRA give priority to proposals that maximize job creation, and benefits to local communities should always be stressed.

As the number of states with renewables portfolio programs continues to change, this is an area that warrants careful attention.

Third, funding applicants need to identify key obstacles to acceptance of the proposal. For instance, DOE's 1705 loan guarantee program requires projects to be "shovel-ready" by September 30, 2011. As a practical matter, this may eliminate proposals that would require a full Environmental Impact Statement (EIS) under the National Environmental Policy Act (NEPA), which normally takes at least a year to complete, in favor of those that can proceed more quickly with a simpler NEPA Environmental Assessment (EA), such as reusing a previously contaminated brownfield, mining site, or industrial facility rather than a pristine "greenfield" location. Funding for numerous federal grant programs was provided by ARRA and has now been allocated. Parties interested in additional funding may want to consider the advisability of a legislative strategy.

Fourth, the support of local and federal political leaders can be critical. DOE has been in touch with states and communities to educate them about the bank-backed funding requirements in its loan guarantee program, with the thought that local assistance in facilitating partnerships between financial institutions and project developers can enhance the success of the application.

Fifth, close coordination among the developer, design and environmental engineers, private-sector financing sources, and lawyers is essential to avoid costly missteps and delays. Most deals involve a combination of private and public funding sources, and good planning results in cost-effective structuring of the project.

Sixth, continuing communications are valuable with the agency administering the grant, rebate, or loan guarantee, or approving the tax credit, to make sure all submissions are complete and to address any issues that arise.

Conclusion

There is no question that navigating the complex web of economic incentive programs for renewable energy development presents daunting challenges. The process may not be intuitively obvious, particularly to private-sector business interests that are more accustomed to direct deal making and decisions driven by economics. However, the government incentive regime has its rules, rhymes, and reasons, even if they are not immediately apparent. These sources of funding can mean the difference in whether a deal happens or not. With a clear understanding of how the programs work and a creative strategy that weaves together technical aspects, policy savvy, and practicality, obtaining some degree of government funding is a realistic goal and can help make the project a reality.

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[1]American Recovery and Reinvestment Act of 2009, Pub.L. 111-5. See A. Bull, "Obama Awards $2.3 Billion Clean Energy Tax Credits," Reuters, Jan. 8, 2010, available at http://news.yahoo.com/s/nm/20100108/ts_nm/us_obama_taxcredit.

[2]H.R. 2847.

[3]Should Congress enact federal climate change legislation with cap and trade provisions, the funding picture for renewable energy projects would change radically. Such a program's requirements for the purchase of greenhouse gas emission allowances and the sale of carbon offsets attributable to renewable energy would create major new funding sources. This issue is not within the scope of this article, but for more information, see Jane C. Luxton and William J. Walsh, "Climate Change Legislation: It's Time for Businesses to Take It Seriously," Pepper Hamilton *Sustainability, Clean Tech, and Climate Change Alert*, July 20, 2009, available at www.pepperlaw.com/publications_update.aspx?ArticleKey=1549.

[4]Energy Policy Act of 2005, Pub.L. 109-58.

[5]These programs have numerous other conditions and "fine print." Additional information is available at DOE's Web site, see www.energy.gov/recovery/renewablefunding.htm.

[6]Unless otherwise stated, all tax-related references to "Section" are to the Internal Revenue Code of 1986, as amended.

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[7]For more information, see Todd B. Reinstein, "American Recover and Reinvestment Act of 2009 Enhances Renewable Energy Tax Provisions," Pepper Hamilton *Energy Tax Alert*, Feb. 18, 2009, available at www.pepperlaw.com/publications_update.aspx?ArticleKey=1397.
[8]See Todd. B. Reinstein, "Treasury Notice 2009-72 with Application Rules for Section 48C," Pepper Hamilton *Energy Tax Alert*, Aug. 14, 2009, available at www.pepperlaw.com/publications-update.aspx?ArticleKey=1575.
[9]See www.treas.gov/recovery/1603.shtml.
[10]See www.energy.gov/recovery/breakdown.htm.
[11]See www07.grants.gov/search/search.do;jsessionid=C1RGLTjMtgG9ymhPy7mKftHTTD7Kpy2GZRTbhZwQrNC52RTK1hJQ!-1179711943?mode=VIEWREVISIONS&revNum-8.
[12]More information is available at the USDA Web site: www.rurdev.usda.gov/ga/tenergy.htm.
[13]See www.dsireusa.org/incentives/index.cfm?EE=1&RE=1&SPV=0&ST=0&searchtype=RPS&sh=1. Passage of a comprehensive energy bill, either as part of climate change legislation or independently, may result in such standards becoming mandatory nationwide.
[14]States that have not traditionally had robust programs are looking to adopt major incentive programs, such as Maryland. See "O'Malley Proposed New Energy Policies," Washington Business Journal (Jan. 15, 2010) http://washington.bizjournals.com/washington/stories/2010/01/11/daily84.html.
[15]See generally www.dsireusa.org/.
[16]Many counties and municipalities offer additional programs.

Uncertain Tax Positions *(from page 3)*

practice not to examine the position." Under FIN 48, it is possible to conclude that a tax position meets the "more likely than not" threshold based on an administrative practice. The Announcement effectively states that if the tax position would require a reserve if administrative practice could not be taken into account, then it must be disclosed.

The Announcement indicates that the IRS will continue the policy of restraint with respect to tax accrual workpapers.

Also under FIN 48, it is possible to conclude that no reserve should be recorded because the taxpayer does not expect to settle but expects to win in litigation. The Announcement effectively states that if a reserve would be recorded on the assumption that a settlement would be entertained by the taxpayer, then the tax position must be disclosed.

Description of Uncertain Tax Position to be Reported

The new schedule will require "a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements." The description must include "a rationale for the position and a concise general statement of the reasons for determining that the position is an uncertain tax position." The Announcement lists six additional requirements that the description must contain, including:

- the Code sections "potentially implicated" by the position;
- identification of the taxable year(s) at issue;
- a statement indicating whether the position involves an item of income, gain, loss, deduction, or credit against tax;
- a statement that the position involves a permanent exclusion of any item, the timing of that item, or both;
- a statement whether the position involves a determination of the value of any property or right;
- a statement whether the position involves a computation of basis.

Workpaper Policy of Restraint Gutted

The Announcement indicates that the IRS will continue the policy of restraint with respect to tax accrual workpapers. The proposal, however, reduces the policy of restraint to a ghost-like state since core information will be on the tax return if the proposal goes through. Further, much of the relevant information that might have enjoyed benefit under the restraint policy will be quickly ascertained via targeted Information Document Requests (IDRs). The stated purpose of the proposed requirements regarding uncertain tax return positions is to assist the IRS to quickly and efficiently identify significant tax issues underlying the tax return, so that the IRS's resources can be better focused. Not surprisingly, the Announcement references FIN 48, but fails to recognize that FIN 48 results in a determination of an accounting position. In contrast, the new IRS proposal results in a qualitative description of a tax return position.

The Announcement is clearly a reflection of the IRS's emboldened attitude following its victory before the First Circuit in *United States v. Textron Inc.*, No. 07-2631 (1st Cir. Aug. 13, 2009). That decision, which has been widely criticized, is being appealed to the U.S. Supreme Court.

The Announcement requests comments concerning the contents of the schedule. Interestingly (although not surprisingly), the issues that the IRS is "particularly interested" in receiving comments on do not include the topic of whether the proposed schedule should be used in the first place.

Proposed Effective Date

The IRS intends to require filing of the new schedule for

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uncertain tax positions to be made with returns filed after the release of the schedule.

[1]The full text of Announcement 2010-9 can be found at http://www.irs.gov/pub/irs-drop/a-10-09.pdf.
[2]FIN 48 is an interpretation issued in June 2006 by the Financial Accounting Standards Board (FASB) of FASB Statement No. 109. FASB is an independent board that determines the generally accepted accounting principles (or GAAP), which are applicable to both public and private companies in the preparation of their financial statements. FASB itself has no enforcement authority. However, the Securities and Exchange Commission requires public companies to follow GAAP, and may bring an enforcement action against any public company that fails to follow GAAP.
[3]Such as the International Financial Reporting Standards or country-specific, generally accepted accounting standards.
[4]The Announcement further states that "the schedule will require a taxpayer to specify for each uncertain tax position the entire amount of the United States federal income tax that would be due if the position were disallowed in its entirety on audit."

CALIFORNIA

The *Apple* Decision: Foreign Dividends in Flux in California

By Kyle O. Sollie and James P. Kleier (Reed Smith)

A California Superior Court's decision last month in the *Apple* litigation should be considered by any water's-edge California franchise taxpayer that has received a foreign dividend.[1] The court concluded that *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.*[2] does "not govern how to order distributions made by a controlled foreign corporation (CFC) to its parent when the distributions are made out of earnings from multiple years."[3] Still, the *Apple* court kept some semblance of the *Fujitsu* preferential ordering approach. (By "preferential ordering," we mean that previously taxed earnings are counted in some way before untaxed earnings in determining whether a dividend is eliminated. A preferential ordering approach, which has various flavors, contrasts with a pro-rata approach in which any dividend is deemed equally divided between the two types of earnings. Preferential ordering, of course, is better for taxpayers.) Specifically, the court concluded that:

> . . . a distribution is deemed paid entirely from included income of a CFC's most recent year's earnings until exhausted. Then the remainder of the distribution is deemed drawn from the excluded income of the most recent year. When that source is exhausted, the remainder is deemed paid from the included income of the previous year and so on until the entire amount of the distribution is accounted for.[4]

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For Apple, and many other taxpayers receiving dividends from foreign subsidiaries, the court's ordering of distributions results in a large portion of any dividend from a foreign subsidiary being deductible, not excludible. Under California law, an exclusion is almost always preferable to a deduction.[5]

Although the court ruled for the FTB on the dividend exclusion issue, it ruled for Apple on the portion of the case dealing with California's foreign investment interest offset provisions. Under those provisions, a taxpayer may lose interest deductions unless it can prove that the interest was not attributable to its investment in the foreign subsidiaries that paid deductible dividends.[6] The court concluded that Apple did not borrow to benefit its foreign dividend payors; instead, it borrowed to benefit its domestic operations.[7] As a result, the court held that the debt was not incurred for purposes of foreign investment, and no interest offset was required.

The *Apple* decision creates a refund opportunity for any corporation with foreign subsidiaries that has lost interest expense deductions under California's foreign interest offset provisions.

Although Apple didn't get everything it asked for, this decision is likely to be appealed. Therefore, all California water's-edge franchise taxpayers that have

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received dividends from a foreign subsidiary should review the ordering applied to their foreign dividends to see if they have a refund opportunity under the preferential ordering approach that Apple advocated. Franchise taxpayers that repatriated foreign earnings to take advantage of the American Jobs Creation Act of 2004 and repatriated foreign earnings in 2005 may need to act quickly to take advantage of this refund opportunity. For many of these taxpayers, the four-year statute of limitations for refunds expires this fall.

In addition, the Superior Court's decision in *Apple* creates a refund opportunity for any corporation with foreign subsidiaries that has lost interest expense deductions under California's foreign interest offset provisions. Such a corporation may now be able to deduct its interest expense from its non-dividend income if it can demonstrate that the underlying debt was not incurred for the purposes of investing in its foreign subsidiaries.

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[1]*Apple Inc. v. Franchise Tax Bd.*, No. CGC 08-471129 (Cal. Sup. Ct., Jan. 26, 2010). For a copy of the opinion, see www.reedsmith.com/AppleSF.
[2]120 Cal. App. 4th 459 (Cal. Ct. App. 1 Dist. 2004).
[3]*Apple Inc.*, Final Statement of Decision, *slip op.* at 2.
[4]*Id.* at 6.
[5]For a detailed white paper on this issue, see www.reedsmith.com/ApplePaper.
[6]See, e.g., *Great Western Fin. Corp. v. Franchise Tax Bd.*, 4 Cal. 3rd 1 (Cal. 1971).
[7]*Id.* at 12-13.

NEW YORK

Budget Proposal for New York Addresses Bank Tax, Affiliate Nexus, Asset Sales, Credits, and Other Changes

By Greg Lee, Brian Goldstein, Jack Kramer, Peter Michalowski, Virginia Gates, John Verde and James Bartek (PricewaterhouseCoopers)

On January 19, 2010, New York Governor David Paterson released proposed budget legislation that would extend bank tax and transitional provisions related to the Gramm-Leach-Bliley Act, narrow affiliate nexus rules, allow for statistical sampling for sales-use tax audits, subject nonresidents to income tax on termination agreements and non-compete covenants, address the tax treatment of deemed asset sales by S corporation shareholders, amend credits, and make other changes. [2010-11 New York State Executive Budget, Revenue Article VII Legislation, released 1/19/10]

Extension of Bank Tax and Transitional Provisions Related to Gramm-Leach-Bliley Act (Part Y)

The legislation would extend for another year, until taxable years beginning before January 1, 2011, the provisions of Article 32 and the transitional provisions relating to the enactment and implementation of the federal Gramm-Leach-Bliley Act. These changes would also apply for New York City tax purposes.

Affiliate Nexus (Part S)

Background: Under budget legislation enacted in 2009, the presence of an in-state affiliate in New York makes an out-of-state affiliate a vendor if (1) the in-state affiliate uses in the state a trademark, service mark, or trade name the same as or similar to the remote affiliate; or (2) the in-state affiliate engages in activities that help the remote affiliate develop or maintain a market in the state for its goods or services, to the extent those activities satisfy U.S. Constitutional nexus standards, effective June 1, 2009.

> **The legislation would "clarify" that S corporation shareholders that made an election under IRC Secs. 338(h)(10) and 453 must treat the income as income from the sale of assets.**

Current Proposal: The 2010-2011 budget proposal would provide that a seller would not be deemed a vendor if the in-state activities of an affiliate are limited to providing accounting or legal services, or in directing the activities of a seller including, but not limited to making decisions about strategic planning, marketing, inventory, staffing,

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distribution, or cash management, effective June 1, 2009.

Statistical Sampling (Part I)

The legislation would authorize the Commissioner of Taxation and Finance to conduct sales and use tax audits using generally accepted statistical sampling techniques. Such techniques would only be used for taxpayers whose gross receipts are at least $1 million in each of the three taxable years for federal income tax purposes that immediately precede the calendar year in which the audit commences.

Nonresident Compensation for Past Services (Part E)

Under the legislation, New York source income would include income from covenants not to compete and termination agreements received by non-residents for past employment services in New York, applicable to taxable years beginning on or after January 1, 2010.

Asset Sales (Part F)

The legislation would "clarify" that S corporation shareholders that made an election under IRC Secs. 338(h)(10) and 453 must treat the income as income from the sale of assets. As explained in the memorandum of support, this provision addresses: (1) the tax appeals tribunal decision of *Matter of Gabriel S. Baum*, which found that notwithstanding a Sec. 338(h)(10) election to treat the sale of stock as an asset sale of the S corporation, the transaction was a stock sale; and (2) *Matter of Mintz*, an ALJ decision, which held that an election by a subchapter S shareholder under IRC Sec. 453, with respect to a liquidation by installment contract, did not apply for state tax purposes and treated the liquidation as a stock sale. This provision would apply to all tax years open for a refund or assessment. In addition, the legislation would provide that where an S corporation has terminated its taxable status in New York, the income from an installment sale contract would continue to constitute New York source income for the nonresident shareholders as it is received, applicable to tax years beginning on or after January 1, 2010.

Other Provisions

In addition, the legislation would:

- increase the excise tax on cigarettes by $1.00 per pack (Part B);
- impose an excise tax on syrups, bottled soft drinks, and "powder or base products" effective September 1, 2010 (Part C);
- require the Department of Taxation and Finance to complete a report that examines the statutory and policy options designed to achieve the goal of improved taxation of communication services in New York state (including, but not limited to, wireline and wireless telecommunication services, telecommunication services using voice over internet protocol, and cable and satellite television services), and the state and local revenue implications of those options (Part M);
- establish the "Excelsior Jobs Program," which would provide a jobs tax credit, investment tax credit, and research and development credit for biotechnology, pharmaceutical, high-tech, green-tech, financial service, and manufacturing businesses (Part W);
- clarify the Legislature's intent that 2009 amendments that require the revocation of certification of certain business entities previously certified under the empire zones program are intended to be effective for the taxable year in which the decertification occurs and for all subsequent taxable years. Decertifications that occurred in 2009 would be deemed to be in effect for the taxable year commencing on or after January 1, 2008 and before January 1, 2009 (Part X); and
- expand the film production credit by providing an additional $2.1 billion in credits ($420 million per year) from 2010 through 2014, and provide additional requirements for receiving the credit (Part V). ❑

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Oregon Voters Approve Increases of Minimum Corporate Tax, Rates for Large Corporations and High-Income Individuals

By Scott Remington, Steve Jensen, Giles Sutton, Jamie C. Yesnowitz and Chuck Jones (Grant Thornton LLP)

At a special election held on January 26, 2010, Oregon voters approved a measure that provides a new sliding scale for determining minimum corporate tax and increases the tax rate for large corporations.[1] Also, voters approved a measure that creates two new personal income tax brackets for high-income individuals.[2] The tax increases are effective for tax years beginning on or after January 1, 2009. The legislation was enacted last year,[3] but a group of citizens successfully petitioned to have the tax increases considered by the voters at the special election.

Corporate Tax Increases

Minimum Tax

For tax years beginning on or after January 1, 2009, Oregon revamps the minimum corporate tax by installing a sliding scale based on Oregon sales as determined under the state's sales factor rules.[4] Prior to amendment, Oregon imposed a $10 minimum tax on all C corporations subject to the corporate excise tax and all S corporations. The new minimum tax for C corporations and affiliated groups ranges between $150 for taxpayers with less than $500,000 of Oregon sales to $100,000 for taxpayers with $100 million or more of Oregon sales. There are a total of 12 different levels of minimum tax that can be imposed, depending upon the amount of Oregon sales. In effect, a tax of approximately 0.1 percent is imposed on gross sales equal to each minimum bracket amount. The amended statute provides a definition of "Oregon sales" for purposes of the new minimum corporate tax.[5]

Corporate Income/Excise Tax Rates

Measure 67 adds progressivity to the state's corporate income/excise tax rate, which stood at 6.6 percent for all companies prior to 2009. For tax years beginning on or after January 1, 2009 and before January 1, 2011, the 6.6 percent tax rate is applied to corporate taxable income up to $250,000.[6] When corporate taxable income exceeds $250,000, a 7.9 percent rate applies. The higher income tax bracket is scheduled to be reduced from 7.9 percent to 7.6 percent for tax years beginning on or after January 1, 2011 and before January 1, 2013. For tax years beginning on or after January 1, 2013, the 6.6 percent corporate tax rate will become applicable for taxpayers with corporate taxable income up to $10 million, while corporate taxable income exceeding $10 million will continue to be taxed at 7.6 percent.[7]

New Personal Income Tax Brackets

Measure 66 adds progressivity to the state's personal income tax by creating two new income tax brackets for high-income individuals.[8] Prior to 2009, most levels of taxable income were taxed at a 9 percent tax rate. For tax years beginning on or after January 1, 2009 and before January 1, 2012, single and married individuals filing separately with taxable income over $125,000 but not over $250,000 are subject to a 10.8 percent tax rate on such income, while taxable income over $250,000 will be subject to an 11 percent tax rate.[9] The 10.8 percent tax rate is applicable to joint filers, heads of households and surviving spouses with taxable income over $250,000 but not over $500,000, with the 11 percent tax rate applicable to income over $500,000. Beginning with the 2012 tax year, these two new brackets are scheduled to be combined into one, taxing all income over $125,000 for single and married individuals filing separately (all income over $250,000 for joint filers, heads of households and surviving spouses) at 9.9 percent.[10] The new law also reduces or eliminates the deduction for federal income taxes paid for most high-income taxpayers.[11]

The increase in the corporate minimum tax will be extremely significant for some corporations.

Commentary

The Oregon voters historically have rejected tax increases and the imposition of a sales tax. However, proponents of the measures argued that the tax increases were necessary for education, public safety and healthcare.[12] The tax rate increases are limited to large corporations and high-income individuals. While other states have temporarily increased taxes on high-income individuals in the past couple of years, Oregon is permanently imposing a higher tax rate on these individuals.

The increase in the corporate minimum tax will be extremely significant for some corporations. The $100,000 minimum tax for companies with a sufficiently large Oregon

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presence as measured by the sales factor is unlike any minimum tax currently imposed by a state on corporations. This tax could adversely affect companies in loss positions that otherwise would not have substantial Oregon income tax liability.

Additionally, Oregon has yet to issue guidance with respect to the utilization of net operating loss carryforwards and credits (Oregon is generally quite generous with respect to the availability of research and experimentation credits and business energy tax credits). Based on the current law now in effect, some taxpayers that have their income tax reduced by these loss carryforwards or credits effectively may not receive any benefit due to the minimum tax regime.

Furthermore, special consideration should be given to the impact that the increase in the corporate tax rate may have on ASC 740 (formerly FAS 109) computations, as well as the presentation of the corporate tax on their income statements (income taxes versus minimum taxes which are not based on income).

[1]Measure 67, Unofficial Election Results, Oregon Secretary of State, January 27, 2010. Approximately 53 percent of the voters approved this measure.
[2]Measure 66, Unofficial Election Results, Oregon Secretary of State, January 27, 2010. Approximately 54 percent of the voters approved this measure.
[3]Ch. 745 (H.B. 3405), Ch. 746 (H.B. 2649), Laws 2009.
[4]OR. REV. STAT. § 317.090(2).
[5]OR. REV. STAT. § 317.090(1).
[6]OR. REV. STAT. § 317.061.
[7]*Id.*
[8]Ch. 746 (H.B. 2649), Laws 2009.
[9]OR. REV. STAT. §§ 316.037, 316.042.
[10]*Id.*
[11]OR. REV. STAT. § 316.695(3).
[12]Arguments in Favor of Measures 66 and 67, Online Voters' Guide for January 26, 2010 Special Election, Oregon Secretary of State. ❑

VIRGINIA

"Amazon" Law Introduced in Virginia General Assembly

By Craig D. Bell and J. Christian Tennant (McGuireWoods LLP)

Virginia has joined the growing list of states that will consider adopting a law to require certain Internet retailers to collect Virginia sales tax from its Virginia customers even if the retailer is not physically located in Virginia. This law, commonly referred to as an "Amazon" law after Internet retailer Amazon.com, has been adopted by New York, North Carolina, and Rhode Island. Senate Bill 660, introduced by Senator Emmett W. Hanger Jr. (Augusta County), was passed by the Senate on February 16, and will now move to the House for consideration. The Bill is substantively identical to the Amazon laws adopted by New York, North Carolina, and Rhode Island. Among other states, California, Connecticut, Hawaii, Illinois, Maryland, Minnesota, and Tennessee have considered legislation to adopt an Amazon law in their respective legislatures. None of these states have adopted an Amazon law although the legislatures in California and Hawaii passed the legislation only to see their respective governors veto the legislation. In addition to Virginia, Colorado, Mississippi, New Mexico, and Vermont will consider adopting an Amazon law this year.

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Web Page Link can Create "dealer"

Under current Virginia law, all "dealers" who solicit business in Virginia by employees, independent contractors, agents, or other representatives are required to collect and remit Virginia sales tax on their sales. Senate Bill 660 adds a presumption that dealers will be soliciting in Virginia if the dealer enters into an agreement with a Virginia resident under which the resident receives consideration for referring potential customers to the dealer. Referrals may occur by a link on an Internet site. The dealer would be presumed to be soliciting business if its Virginia sales to purchasers who are referred to the dealer by a Virginia resident are in excess of $10,000 during the preceding four quarterly periods. This presumption may be rebutted by proof that the Virginia resident did not engage in any solicitation in Virginia on

If Virginia adopts the law, Internet retailers should review their solicitation practices in Virginia to determine if they will be required to collect Virginia sales tax.

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behalf of the dealer.

Amazon laws have been a large source of controversy in state and local taxation since first adopted by New York in 2008. Amazon.com and Overtsock.com are currently litigating whether the New York Amazon law violates the United States Constitution on Commerce Clause and Due Process grounds. Upon adoption of the Amazon laws in North Carolina and Rhode Island, Amazon.com terminated all affiliate agreements in these states prior to the law going into effect to ensure that it would not have to collect the respective sales tax.

Conclusion

As this is the first time this law has been introduced in the Virginia General Assembly, it is difficult to predict the reaction Senate Bill 660 will receive from the House of Delegates or Governor Bob McDonnell. If Virginia moves toward adopting the Amazon law, Internet retailers should review their solicitation practices in Virginia to determine if they will be required to collect Virginia sales tax under this law. ❑

Budget Tax Proposals *(from page 2)*

credit, which is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The proposal would make the R&E tax credit permanent, effective as of January 1, 2010.

• *Eliminate Capital Gains Taxation on Investments in Small Business Stock.* Under current law, taxpayers other than corporations may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. In general, small business stock is stock of a domestic corporation engaged in an active trade or business with gross assets not in excess of $50 million. Under the American Recovery and Reinvestment Act of 2009, the exclusion is increased to 75 percent for stock acquired after February 17, 2009, and before January 1, 2011. The taxable portion of the gain is taxed at a maximum rate of 28 percent. Under current law, seven percent of the excluded gain is a tax preference item subject to the alternative minimum tax (AMT). The proposal would exclude 100 percent of the gain from tax, and would eliminate the AMT preference item. The proposal would be effective for qualified small business stock issued after February 17, 2009.

• *Remove Cell Phones from "Listed Property" Category.* Under current law, a taxpayer must maintain adequate records detailing the business use of listed property, such as cell phones, automobiles, and computers. In addition, the depreciation deductions and small business expensing deduction are subject to limitations. The proposal would remove cell phones from the category of listed property, effective for taxable years ending after the date of enactment.

• *Increase Certainty with Respect to Worker Classification.* The classification of workers as employees or independent contractors is generally based on a common-law test to determine whether the service recipient has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result. This test has led to substantial uncertainty in the administration of the tax laws, and in the determination of whether workers are entitled to certain benefits. The Service has been prohibited since 1978 from issuing generally applicable guidance regarding worker classification. This prohibition would be removed, and the Service could issue generally applicable guidance. In addition, the Service would be authorized to require prospective reclassification of workers. The proposal would be effective upon enactment.

• *Repeal the Last-In, First-Out (LIFO) Method of Inventory Accounting.* Under current law, a taxpayer can determine the cost of its inventories using the LIFO method, which treats the most recently acquired (or manufactured) items as having been sold during the year. The LIFO method provides a tax benefit for a taxpayer with rising inventory costs, because the cost of goods sold is based on more recent, higher inventory values, resulting in lower taxable income. To be eligible to elect LIFO for tax purposes, a taxpayer must use LIFO for financial accounting purposes. The proposal would repeal the use of the LIFO method for taxable years beginning after December 31, 2011. Taxpayers would be required to write up the value of their LIFO inventory to its first-in, first-out value. The resulting increase in gross income would be taken into account ratably over ten taxable years, beginning with the year of change.

• *Repeal the Use of Lower of Cost or Market (LCM) Method of Inventory Accounting.* Taxpayers not using a LIFO method may currently write down the carrying values of their inventories by applying the LCM method, and may write down the cost of "subnormal" goods, i.e., those that are unsalable at normal prices or unusable in the normal way because of damage, imperfection, or other similar causes. The proposal would repeal the use of the LCM and subnormal goods methods, effective for taxable years beginning after twelve months from the date of enactment. Further, taxpayers would be allowed to use the retail method only if they used the method for financial reporting purposes. Any adjustment resulting from these changes would generally be taken into account ratably over four taxable years, beginning with the year of change.

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• *Tax Carried (Profits) Interests as Ordinary Income.* The income and loss of a partnership retains its character and flows through to the partners, who include such items on their tax returns. A partner may receive a partnership interest in capital or future profits in exchange for the contribution of cash and/or property, or in exchange for services. Partnership interests received in exchange for services are frequently profits interests rather than interests in the capital of the partnership. Accordingly, if a partnership recognizes long-term capital gain, the partners, including partners who provide services, include 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 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 income that is excluded from self-employment taxes, such as capital gains.

Taxpayers would be required to write up the value of their LIFO inventory to its first-in, first-out value.

The proposal would tax a partner's share of income from a "services partnership interest" (SPI) as ordinary income, regardless of the character of the income to the partnership. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains of individuals. In addition, the partner would be required to pay self-employment taxes on such income. Gain recognized on the sale of an SPI would generally be taxed as ordinary income. 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" (money or other property) 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. Under an anti-abuse rule, similar treatment would be required for a "disqualified interest" such as convertible or contingent debt, an option, or any similar instrument. The proposal would be effective for taxable years beginning after December 31, 2010.

• *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, including on a forward sale (a sale in the future for consideration to be paid in the future) of its own stock. While a corporation does not recognize gain or loss on the issuance of its own stock, it does recognize interest income upon the current sale of stock for deferred payment. The proposal would require a corporation that enters into a forward sale of its stock to treat a portion of the payment as interest. The proposal would be effective for forward contracts entered into after December 31, 2011.

• *Require Ordinary Treatment for Certain Dealers of Equity Options and Commodities.* Generally, dealers in property treat the income from their day-to-day activities as ordinary income. However, commodities dealers, commodities derivatives dealers, dealers in securities, and options dealers treat the income from their day-to-day activities as capital gain or loss. Currently, 60 percent of the gain or loss is long-term capital gain or loss and 40 percent of the gain or loss is short-term capital gain or loss. The proposal would require these dealers to treat the income from their day-to-day activities as ordinary income or loss. The proposal would be effective for taxable years beginning after the date of enactment.

• *Extend Bonus Depreciation.* In the case of property placed in service in 2008 and 2009, an additional first-year depreciation deduction equal to 50 percent of the cost of qualified property is allowed. Qualified property generally includes tangible property with a recovery period of 20 years or less, certain computer software, and qualified leasehold improvement property. The proposal would extend the additional first-year depreciation deduction to property acquired and placed in service in 2010 (or placed in service in 2011 for certain property). The proposal would be effective for property placed in service after December 31, 2009.

• *Modify Definition of Control for Purposes of Section 249.* In general, if a corporation repurchases a debt instrument that is convertible into its stock or the stock of a corporation in control of or controlled by the corporation, section 249 may limit or disallow the deduction for a premium paid to repurchase the debt. Under current law, "control" is defined to include only a direct relationship, such as an immediate parent corporation and its first-tier subsidiary. The proposal would amend the definition of control to include indirect relationships, such as an ultimate parent corporation and a lower-tier subsidiary. The proposal would be effective on the date of enactment.

• *Deny Deduction for Punitive Damages.* No deduction is allowed for a fine or similar penalty paid to a government for the violation of any law. If a taxpayer is convicted of a violation of the antitrust laws, or enters a plea of guilty or *nolo contendere* (no contest) to such a violation, no deduction is allowed for two-thirds of any amount paid or incurred on a judgment or in settlement of certain civil suits. If neither of these two provisions applies, a deduction is allowed for compensatory and punitive damages. The proposal would deny a deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, the damages paid by the insurer would be included in the gross income of the insured person. The

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insurer would be required to report such payments to the insured person and to the Service. The proposal would apply to damages paid or incurred after December 31, 2011.

• *Reinstate the Superfund Excise Taxes and the Superfund Corporate Environmental Income Tax.* Prior to January 1, 1996, Superfund excise taxes were imposed on *(i)* domestic crude oil and imported petroleum products at a rate of $0.097 per barrel; *(ii)* listed hazardous chemicals at various rates; and *(iii)* imported substances that use hazardous materials in their production. In addition, the Superfund environmental income tax was imposed on corporations at a rate of 0.12 percent on the excess of modified alternative minimum taxable income over $2 million. Under the proposal, the excise taxes would be reinstated for periods after December 31, 2010, and would sunset after December 31, 2020. The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 2010, and would also sunset for taxable years beginning after December 31, 2020.

• *Repeal Credit for Enhanced Oil Recovery Projects.* Current law provides a 15-percent credit for costs attributable to enhanced oil recovery projects. The proposal would repeal this credit, effective for taxable years beginning after December 31, 2010.

• *Repeal Credit for Production from Marginal Wells.* Current law provides a tax credit for crude oil and natural gas produced from marginal wells. The credit rate is $3.00 per barrel of oil and $0.50 per 1,000 cubic feet of natural gas. The proposal would repeal the credit for production in taxable years beginning after December 31, 2010.

• *Repeal Expensing of Intangible Drilling Costs.* Generally, costs that benefit future periods must be capitalized and recovered over those periods. However, an operator who pays or incurs intangible drilling costs in the development of an oil or gas property in the United States can elect to either capitalize the costs or deduct them in the year paid or incurred. The proposal would repeal the current deduction of intangible drilling costs. Such costs would be capitalized and recovered under the generally applicable rules. This proposal would be effective for costs paid or incurred after December 31, 2010.

• *Repeal Deduction for Tertiary Injectants.* Under current law, taxpayers may deduct the cost of qualified tertiary injectant expenses. The proposal would repeal the deduction and require the costs to be capitalized. The proposal would be effective for amounts paid or incurred after December 31, 2010.

• *Repeal Passive Loss Exception for Working Interests in Oil and Gas Properties.* Under current law, deductions and credits from passive trade or business activities are generally limited to the income from passive activities, and may not be claimed against income from other sources. Any deductions or credits that cannot be claimed currently can be carried forward. The passive loss limitations do not apply to deductions and credits from a working interest in an oil or gas property. The proposal would repeal the exception from the passive loss rules, effective for taxable years beginning after December 31, 2010.

• *Repeal Percentage Depletion.* The capital costs of oil and gas wells and coal and other hard mineral fossil fuel properties are recovered through deductions for depletion rather than through depreciation. In lieu of cost depletion, certain taxpayers may claim percentage depletion deductions. The percentage depletion is a statutory percentage, which ranges from 10 to 25 percent, of the gross income from the property. The proposal would repeal percentage depletion for oil and gas wells and coal and other hard mineral fossil fuel properties, effective for taxable years beginning after December 31, 2010.

• *Repeal Domestic Manufacturing Deduction for Fossil Fuel Production.* A deduction is allowed with respect to income attributable to domestic production activities. For taxable years beginning after 2009, the deduction is equal to nine percent of the lesser of qualified production activities income for the year or taxable income for the year, limited to 50 percent of the Form W-2 wages of the taxpayer, except that in the case of oil and natural gas production activities, the deduction is computed at six percent. The proposal would exclude from the computation of the deduction all gross receipts from the sale, exchange, or other disposition of *(i)* oil, natural gas, or their primary products, and *(ii)* coal, hard mineral fossil fuels, or their primary products. The proposal would be effective for taxable years beginning after December 31, 2010.

• *Increase the Amortization Period for Geological and Geophysical Cost.* Under current law, the amortization period for geological and geophysical costs incurred in connection with oil and gas exploration is two years for independent producers and seven years for integrated oil and gas producers. The proposal would make the amortization period seven years for all taxpayers, effective for amounts paid or incurred after December 31, 2010.

• *Repeal Expensing of Exploration and Development Costs.* Under current law, a taxpayer may expense the costs of exploring for ore and mineral deposits and developing the property. Under the proposal, exploration and development costs relating to coal and other hard mineral fossil fuels would be capitalized and recovered through depreciation or depletion. The proposal would be effective for costs paid or incurred after December 31, 2010.

• *Repeal Capital Gains Treatment of Certain Royalties.* Under current law, royalties received on the disposition of coal and lignite generally qualify for capital gains treatment. Under the proposal, royalties from the disposition of coal and lignite would be taxed as ordinary income, effective for taxable years beginning after December 31, 2010.

• *Modify the Dividends Received Deduction for Life Insurance Company Separate Accounts.* Corporate taxpayers are generally entitled to a dividends received deduction with respect to dividends from a domestic corporation. The deduction is available to a life insurance company only with respect to the company's share of the dividends. The Service and life insurance companies have disagreed over the

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computation of the company's share. The proposal would modify the formula used to determine the company's share of dividends received. The proposal would be effective for taxable years beginning after December 31, 2010.

Individual Tax Provisions

• *Tax Rates.* In 2001, the tax rates applicable to individuals were reduced through December 31, 2010. The top tax bracket was reduced from 39.6 percent to 35 percent, and the second highest tax bracket was reduced from 36 percent to 33 percent. The proposal would reinstate the 36-percent and 39.6-percent tax brackets, but would permanently extend the other tax rates. The 36 percent rate would apply at $250,000 for married taxpayers filing jointly and $200,000 for single taxpayers. The 39.6-percent rate would apply to incomes above $373,650. These amounts would be adjusted for inflation and would be effective January 1, 2011.

• *Reinstate the Limitation on Itemized Deductions.* Prior to 2001, certain otherwise allowable itemized deductions were reduced by three percent of the amount by which adjusted gross income (AGI) exceeded a statutory floor that was indexed annually for inflation, but not by more than 80 percent of the otherwise allowable deductions. As part of the 2001 tax legislation, this limitation on itemized deductions has been reduced in stages. For 2009, itemized deductions were reduced by one percent of AGI over the threshold of $166,800, but not by more than 26. percent. For 2010, the reduction was to be completely eliminated. However, beginning in 2011, the full itemized deduction reduction of three percent of AGI exceeding the floor is scheduled to be reinstated. The proposal would allow the reinstatement of the limitation to become effective in 2011. For 2011, the threshold would be adjusted for inflation starting with a value of $250,000 in 2009 for married taxpayers filing jointly ($125,000 if filing separately) and $200,000 in 2009 for single taxpayers. After 2011, the thresholds will be indexed for inflation.

• *Reinstate the Personal Exemption Phase-Out.* Individual taxpayers generally are entitled to a personal exemption for the taxpayer and for each dependent. Prior to 2001, the personal exemptions were reduced or completely phased out for higher-income taxpayers. For a taxpayer with AGI in excess of the threshold amount, the amount of each personal exemption was reduced by two percent of the exemption amount for that year for each $2,500 ($1,250 if married filing separately) or fraction thereof by which AGI exceeded that threshold. The 2001 act reduced the otherwise-applicable reduction of personal exemptions by two-thirds for 2008 and 2009, and eliminated it completely for 2010. However, beginning in 2011, the full personal exemption phase-out is scheduled to be reinstated. The proposal would permanently repeal the personal exemption phase-out, except for higher income taxpayers. The AGI levels at which the phase-out begins would be adjusted. For 2011, the AGI floors would be adjusted for inflation starting with a value of $250,000 in 2009 for married taxpayers filing jointly ($125,000 if filing separately) and $200,000 in 2009 for single taxpayers.

• *Limit the Tax Rate at which Itemized Deductions Reduce Tax Liability to 28 Percent.* Under current law, itemized deductions reduce a taxpayer's income subject to tax, subject to the limitation on itemized deductions discussed above. The benefit of the itemized deduction is effectively the product of the marginal rate applicable to the taxpayer times the itemized deduction. The proposal would limit the benefit of itemized deductions to 28 percent, rather than the 36 or 39.6 percent rates that would otherwise be applicable. The proposal would be effective for taxable years beginning after December 31, 2010.

• *Impose a 20-Percent Maximum Rate on Dividends and Capital Gains.* Under current law, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. These rates apply for purposes of both the regular tax and the AMT.

The proposal would tax a partner's share of income from a "services partnership interest" as ordinary income, regardless of the character of the income to the partnership.

Qualified dividends generally are taxed at the same rate as capital gains. The zero- and 15-percent rates for dividends and capital gains are scheduled to sunset for taxable years beginning after December 31, 2010. The proposal would permanently extend the zero- and 15- percent rates, and would create a 20-percent rate on long-term capital gains and qualified dividends. The higher rate would apply at the same levels as the 36-percent rate for taxpayers generally (see above).

• *Extend the "Making Work Pay" Credit.* In 2010, individual taxpayers are eligible for a refundable tax credit of 6.2 percent of earned income up to a maximum credit of $400 ($800 for joint filers). Thus, workers receive a credit on the first $6,452 of earned income ($12,903 for joint filers). The credit phases out at a rate of two percent for taxpayers with modified AGI in excess of $75,000 ($150,000 for joint filers). The credit expires at the end of 2010. The proposal would extend the credit for one year.

• *Permanently Extend the American Opportunity Tax Credit.* The credit equals 100 percent of the first $2,000 plus 25 percent of the next $2,000 of qualified tuition and related expenses (including textbooks), for a maximum credit of $2,500. Forty percent of the otherwise allowable credit is refundable (for a maximum refundable credit of $1,000). The credit is available for the first four years of post-secondary education, and phases out for taxpayers with AGI between $80,000 and $90,000 ($160,000 and $180,000 if married filing jointly). The proposal would make the credit permanent, and would index the $2,000 tuition and expense amounts,

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as well as the phase-out thresholds, for inflation. The proposal would be effective for taxable years beginning after December 31, 2010.

• *Expand the Saver's Credit and Provide for Automatic Enrollment in IRAs.* A nonrefundable tax credit is available for eligible individuals who make voluntary contributions to 401(k) plans and other retirement plans, including individual retirement accounts (IRAs). The maximum annual contribution eligible for the credit is $4,000 for married couples filing jointly and $2,000 for single taxpayers or married individuals filing separately, resulting in maximum credits of $2,000 and $1,000, respectively. The credit rate is 10 percent, 20 percent, or 50 percent, depending on the taxpayer's AGI. The proposal would make the saver's credit fully refundable and would replace the current three rates with a refundable credit of 50 percent of the first $500 of contributions, indexed for inflation beginning in 2012. The provisions related to the saver's credit would be effective December 31, 2010. In addition, employers in business for at least two years that have ten or more employees would be required to offer an automatic IRA option to employees on a payroll-deduction basis, under which regular payroll-deduction contributions would be made to an IRA. Employers could claim a temporary tax credit for making automatic payroll-deposit IRAs available to employees. The amount of the credit would be $25 per enrolled employee up to $250.

Estate and Gift Tax Provisions

• *Rates.* Under the 2001 tax legislation, the rate of tax on estates and gifts has been reduced, and the amount that is exempt from tax has been increased each year. The estate tax was repealed effective January 1, 2010, but is scheduled to be reinstated at the 2001 rates and exemption amounts on January 1, 2011. The proposal is to extend the estate and gift taxes at the rates in effect in 2009 (a top rate of 45 percent), with an exemption amount of $3.5 million.

• *Require Minimum Term for Grantor Retained Annuity Trusts (GRATs).* Under current law, the present value of an annuity interest retained by the grantor of a GRAT is deducted from the fair market value of the property transferred to the trust for purposes of determining the amount subject to gift tax. The proposal would require that a GRAT have a minimum term of ten years. The proposal would apply to trusts created after the date of enactment.

• *Require Consistency in Value for Transfer and Income Tax Purposes.* The proposal would provide that the basis of property acquired from a decedent be the value of that property for estate tax purposes. The basis of property received as a gift would be the donor's basis, increased by the gift tax paid on the transfer, but not in excess of the fair market value of the property at the time of the transfer (in the case of a subsequent sale at a loss). In general, these rules are not substantively different from the provisions of current law. However, the proposal would impose an affirmative duty of consistency between the estate and the beneficiary, or the donor and the donee, as the case may be. In furtherance of this new duty of consistency, the executor of the estate or the donor of the gift would be required to report the necessary information to both the recipient and the Service. The proposal would be effective as of the date of enactment.

• *Modify Rules on Valuation Discounts.* Generally, the fair market value of property is subject to estate or gift tax at the time of its transfer. The fair market value of the property may be affected by restrictions on the property. The proposal would create an additional category of restrictions that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transfer's family. The proposal would apply to transfers, after the date of enactment, of property subject to restrictions created after October 8, 1990.

Administrative Provisions

• *Require Information Reporting on Payments to Corporations.* Businesses are required to report payments of $600 or more made during the year, but generally no reporting is required with respect to payments made to corporations. These payments are generally reported on Form 1099. The proposal would extend the information reporting requirement to payments made to corporations (other than tax-exempt corporations), and would be effective for payments made after December 31, 2010.

• *Require a Certified Taxpayer Identification Number from Contractors.* Businesses making payments of $600 or more to a non-employee service provider (contractor) that is not a corporation are required to report the payment, as well as the name, address, and taxpayer identification number (TIN) to the Service. The identifying information is provided by the contractor, but not verified by the Service. The proposal would require the contractor to provide the business its certified TIN. The business would be required to verify the TIN with the Service, which would be authorized to disclose whether the TIN-name combination matches its records. If the contractor fails to provide an accurate certified TIN, the business would be required to withhold tax at a flat rate on the gross payments. The proposal would be effective for payments made to contractors after December 31, 2010.

• *Increase Information Return Penalties.* The penalty for failure to file an information return is graduated, depending on when the return is filed. The penalty ranges from $15 per return, with a maximum of $75,000 per year, to $50 per return, with a maximum of $250,000 per year. If the failure is due to an intentional disregard of the filing requirement, the penalty is $100 per return, with no maximum. Under the proposal, the penalties would range from $30 per return, with an annual maximum of $250,000, to $100 per return, with an annual maximum of $1,500,000. Reduced maximum penalties would apply to small filers. In the case of an intentional disregard of the filing requirement, the penalty would be $250 per return. The proposal would be effective

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for information returns required to be filed after December 31, 2011.

• *Extend Statute of Limitations Where State Adjustment Affects Federal Tax Liability.* Generally, the Service can assess additional tax liability within three years after the date a return is filed. The Code contains various exceptions that extend the time for assessment. Under the proposal, the statute of limitations would be extended to the greater of *(i)* one year from the date the taxpayer first files an amended return with the Service reflecting adjustments to a State or local tax return or *(ii)* two years from the date the Service first receives information from the State or local agency. The proposal would be effective for returns required to be filed after December 31, 2010.

• *Require E-Filing by Certain Large Organizations.* Corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, are required to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for taxable years ending on or after December 31, 2006. In addition, private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns. The proposal would require all corporations and partnerships required to file Schedule M-3 to file their tax returns electronically. Thus, in effect, the sole criterion for electronic filing will be the same $10 million asset threshold as is applied to the Schedule M-3 requirement. In the case of certain other large taxpayers not required to file Schedule M-3 (such as exempt organizations), the regulatory authority to require electronic filing would be expanded to allow reduction of the current threshold of filing 250 or more returns during a calendar year. The proposal would be effective for taxable years ending after December 31, 2010.

• *Impose a Penalty on Failure to Comply with Electronic Filing Requirement.* Current law imposes a penalty for the failure to file a return. Generally, the failure to file electronically when electronic filing is required is regarded as the failure to file a return. The penalty is based on the amount of tax due. The proposal would establish an assessable penalty for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The amount of the penalty would be $25,000 for a corporation or $5,000 for a tax-exempt organization. For failure to file in any format, the existing penalty would remain, and the proposed penalty would not apply. The proposal would be effective for returns required to be electronically filed after December 31, 2010.

• *Require Information Reporting for Sales of Life Insurance Policies.* Generally, the seller of a life insurance contract has taxable income equal to the difference between the selling price of the contract and the basis in the contract. The proposal would require the purchaser of an interest in a life insurance contract with a death benefit of $500,000 or more to report the purchase price, the buyer's and seller's taxpayer identification numbers, and the issuer and policy number to the Service, the insurance company, and the seller. The proposal would also modify the transfer-for-value rules in order to reduce the types of transactions that could ultimately give rise to tax-exempt insurance proceeds. The proposal would apply to sales or assignments and payments of death benefits for taxable years beginning after December 31, 2010.

• *Require Information Reporting for Private Separate Accounts of Life Insurance Companies.* Generally, the earnings on investments held through a separate account of a life insurance company are tax free or tax deferred. However, if the policyholder has sufficient control over the investments, the policyholder rather than the insurance company is treated as the owner of the investments. The proposal would require life insurance companies to report to the Service and the policyholder the amount of accumulated untaxed income, the total contract value, and the portion of the value invested in one or more private separate accounts. A private separate account is defined as one where a policyholder owns policies whose cash surrender value is at least ten percent of the value of the separate account. The proposal would be effective for taxable years beginning after December 31, 2010.