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SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

January __, 2007.—Ordered to be printed

Mr. BAUCUS, from the Committee on Finance,
submitted the following

REPORT

together with
ADDITIONAL VIEWS

[To accompany S. _____]

The Committee on Finance, having considered an original bill, S. ______, to amend the Internal Revenue Code of 1986 to provide additional tax incentives to employers and employees of small businesses, and for other purposes, reports favorably thereon and recommends that the bill do pass.

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I. LEGISLATIVE BACKGROUND

Since the Fair Labor Standards Act of 1938, Congress has required employers to pay a minimum wage to workers, with some exceptions. Congress enacted the current general minimum wage of $5.15 an hour in 1996. The decade that has passed since then marks the longest period in history without an adjustment to the minimum wage. A majority of states have enacted minimum wages in excess of the current Federal level.

A full-time minimum wage worker earns about $10,712 a year. Roughly two million workers are paid at or below the federal minimum wage. Millions more would be affected by any increase, because many workers earn slightly more than the minimum wage and may also see an increase. According to some research, smaller businesses employ a disproportionate share of workers earning the minimum wage. Small business owners have therefore argued that any increase in the minimum wage should be accompanied by tax incentives targeted for small businesses in order to lower their costs.

The Finance Committee has exclusive jurisdiction over tax matters and held a hearing on January 10, 2007, entitled, "Tax Incentives for Businesses in Response to a Minimum Wage Increase." The Committee heard from a variety of witnesses, including labor economists, small business owners, and tax experts.[1] Following this hearing, the Committee held a mark-up on January 17, 2007, to consider an original bill, S.____ (the "Small Business and Work Opportunity Act of 2007"), a revenue-neutral bill containing a number of tax incentives for small businesses and businesses that hire minimum wage workers. With a majority and quorum present, the Committee favorably reported the bill by unanimous voice vote on that date and this report describes the provisions of the bill. The Committee anticipates that the Senate may consider adding the substance of this bill to H.R. 2, the "Fair Minimum Wage Act of 2007," or similar legislation.

[1] The Committee heard testimony that while increasing the minimum wage would benefit workers through increased wages, a minimum wage increase may also have consequences of employers hiring fewer workers or reducing workers' hours. Others testified that research has shown moderate increases to the minimum wage have little or no adverse employment impact with significant benefits to affected workers.

TITLE I – SMALL BUSINESS TAX RELIEF PROVISIONS

A. Extension of Increased Expensing for Small Business (sec. 101 of the bill and sec. 179 of the Code)

Present Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2009, is $100,000 of the cost of qualifying property placed in service for the taxable year.[2] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2010 is treated as qualifying property. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2010. For taxable years beginning in 2007, the inflation-adjusted amounts are $112,000 and $450,000, respectively.[3]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[4]

For taxable years beginning in 2010 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-

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[2] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[3] Rev. Proc. 2006-53, sec. 2.19, 2006-48 I.R.B. 996 (Nov. 27, 2006).

[4] Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner.[5]

Reasons for Change

The Committee believes that section 179 expensing provides two important benefits for small businesses. First, it lowers the cost of capital for property used in a trade or business. With a lower cost of capital, the Committee believes small businesses will invest in more equipment and employ more workers. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In 2006, Congress acted to extend the increased value of these benefits and the increased number of taxpayers eligible for these benefits for taxable years through 2009. The Committee believes that the changes to section 179 expensing will continue to provide important benefits if extended, and the bill therefore extends these changes for an additional year.

Explanation of Provision

The provision extends for one year the increased amount that a taxpayer may deduct and the other section 179 rules applicable in taxable years beginning before 2010. Thus, under the provision, these present-law rules continue in effect for taxable years beginning after 2009 and before 2011.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

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[5] Sec. 179(c)(2).

B. Fifteen-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Improvements and New Restaurant Buildings (sec. 102 of the bill and sec. 168 of the Code)

Present Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[6] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements and certain qualified restaurant property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2008. Qualified leasehold improvement property is recovered using the straight-line method. Leasehold improvements placed in service in 2008 and later will be subject to the general rules described above.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee).

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[6] Sec. 168.

The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. However, if a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2008. For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method.

Reasons for Change

The Committee believes that taxpayers should not be required to recover the costs of certain leasehold improvements beyond the useful life of the investment. The 39-year recovery period for leasehold improvements for property placed in service after December 31, 2007 extends beyond the useful life of many such investments. Although lease terms differ, the Committee believes that lease terms for commercial real estate are also typically shorter than the 39-year recovery period. In the interests of simplicity and administrability, a uniform period for recovery of leasehold improvements is desirable. Therefore, the provision extends the 15-year recovery period for leasehold improvements.

The Committee also believes that unlike other commercial buildings, restaurant buildings generally are more specialized structures. Restaurants also experience considerably more traffic, and remain open longer than most commercial properties. This daily use causes rapid deterioration of restaurant properties and forces restaurateurs to constantly repair and upgrade their facilities. As such, restaurant facilities generally have a shorter life span than other commercial establishments. The Committee bill extends the 15-year recovery period for improvements made to restaurant buildings, and applies the 15-year recovery period to new restaurants, to more accurately reflect the true economic life of such properties.

Explanation of Provision

The present-law provisions for qualified leasehold improvement property and restaurant improvements are extended for three months (through March 31, 2008). In addition, the three-year rule for restaurant property is repealed. Thus, newly constructed restaurant buildings and restaurant improvements within the first three years also qualify for the 15-year recovery period.

Effective Date

The provision generally applies to property placed in service after December 31, 2007. Repeal of the three-year rule for restaurant property is effective for property placed in service after the date of enactment, the original use of which begins with the taxpayer after the date of enactment.

C. Fifteen-Year Straight-Line Cost Recovery for Qualified Retail Improvement Property (sec. 102 of the bill and sec. 168 of the Code)

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[7] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Generally, depreciation allowances for improvements made on retail property are determined under MACRS. If a retail property improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. A special provision provides a 15-year recovery period for qualified leasehold improvement property.[8]

Reasons for Change

The Committee believes that taxpayers should not be required to recover the costs of certain improvements beyond the useful life of the investment. The present law 39-year recovery period for improvements to owner occupied (i.e., not leased) retail property extends beyond the useful life of many such investments. Therefore, the provision includes a 15-year recovery period for qualified retail improvements.

Additionally, the Committee believes that retailers should not be treated differently based on whether the building in which they operate is owned or leased. The shorter 15-year recovery period for leasehold improvements under present law provides an unfair competitive advantage for those retailers who lease space. As many small business retailers own the building in which they operate their business, the Committee believes this provision will provide relief to small businesses.

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[7] Sec. 168.

[8] Sec. 168(e)(3)(E)(iv).

Explanation of Provision

The provision provides a statutory 15-year recovery period for qualified retail improvement property placed in service before March 31, 2008. For purposes of the provision, qualified retail improvement property means any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public[9] and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

For the purposes of this provision, retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores and convenience stores. However, establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. It is generally intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify for the provision, while those in other industry classes do not qualify under the provision.

Effective Date

The provision applies to property placed in service after the date of enactment.

[9] Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

D. Expand Eligibility for Cash Method of Accounting (sec. 103 of the bill and secs. 446 and 448 of the Code)

Present Law

Section 446(c) of the Code generally allows a taxpayer to select the method of accounting it will use to compute its taxable income provided that such method clearly reflects the income of the taxpayer. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, subject to certain restrictions. Permissible methods include the cash receipts and disbursements method ("cash method"), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary of the Treasury.

Section 448 generally provides that the cash method of accounting may not be used by any C corporation,[10] by any partnership that has a C corporation as a partner, or by any tax shelter. Exceptions are made for farming businesses and qualified personal service corporations. Additionally, an exception is provided for C corporations and partnerships that have a C corporation as a partner if the average annual gross receipts of the taxpayer is $5 million or less for all prior taxable years (including the prior taxable years of any predecessor of the entity). For this purpose, average annual gross receipts is calculated for each tax year by averaging the annual gross receipts for the three-year period ending in such year. The test must be met for all prior tax years beginning after December 31, 1985 in order for a taxpayer to be eligible for the exception.

Section 471 provides that, regardless of a taxpayer's overall method of accounting, the Secretary may require taxpayers to maintain inventories on the accrual method if necessary to clearly reflect income. This requirement is generally applied to taxpayers for whom the production, purchase, or sale of merchandise is an income-producing factor.[11] However, an exception is provided for taxpayers whose average annual gross receipts does not exceed $1 million.[12] Such taxpayers account for inventory as materials and supplies that are not incidental pursuant to Regulations section 1.162-3.[13]

When a taxpayer changes its method of accounting, there is taken into account for the taxable year of the change adjustments to taxable income necessary to prevent amounts from

[10] For this purpose, a tax-exempt trust with unrelated business income is treated as a C corporation with respect to the portion of its activities that constitute an unrelated trade or business. Treas. Reg. sec. 1.448-1T(a)(3).

[11] Treas. Reg. sec. 1.471-1.

[12] Rev. Proc. 2001-10, 2001-02 I.R.B. 272 (January 8, 2001).

[13] Under Treas. Reg. sec. 1.162-3, a deduction is permitted for the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the tax year.

being duplicated or omitted by reason of the change.[14] Positive adjustments (i.e., additions to taxable income), if initiated by the taxpayer and made with the consent of the Secretary, are generally spread over four taxable years beginning in the year of change.[15] Negative adjustments (i.e., reductions to taxable income) are generally taken into account entirely in the year of change.[16]

Reasons for Change

The Committee is sensitive to the trade-off between competing priorities of simplification and accurate income measurement in the tax system. Many taxpayers find the cash method of accounting to be simpler to use than the accrual method, which generally is considered to provide a more accurate measurement of income for each taxable year. The effect of the differences in income measurement is not permanent, as the different methods produce the same total amount of taxable income over time.

The present-law exception for small businesses with gross receipts under $5 million[17] reflects the view that, in the case of small businesses, the benefits of simplification under the cash method outweigh any impact on accuracy. The Committee believes that the threshold has become outdated over time and understates the maximum size of business which should be eligible for use of the cash method. Accordingly, the Committee provision increases the threshold and indexes it for inflation to prevent it from becoming outdated in the future.

Explanation of Provision

Under the provision, eligibility to use the cash method under the annual gross receipts exception is expanded to all non-farm taxpayers other than tax shelters regardless of the presence of inventories, and the threshold for the exception is increased from $5 million to $10 million.

The provision also resets the December 31, 1985 testing start date. Under the provision, the gross receipts test must be met for all tax years ending on or after the date of enactment. Thus, a taxpayer who did not meet the $5 million gross receipts test in one or more years ending prior to the date of enactment but meets the new $10 million test for all tax years ending on or after the date of enactment is eligible to use the cash method under the provision.

The $10 million threshold is indexed for tax years beginning in calendar years after 2008. The indexed amount applies in each year for the purposes of testing the average annual gross receipts, calculated based on the prior three tax years. Once a taxpayer has either met or not met the gross receipts test with respect to a particular tax year, that result cannot subsequently be

[14] Sec. 481.

[15] Rev. Proc. 2002-19, 2002-1 C.B. 696.

[16] Ibid.

[17] The threshold is $1 million with respect to inventory accounting.

changed by the effect of the indexing. Thus, a tax year that ends on or after the date of enactment for which the gross receipts test is not met causes the taxpayer to be ineligible to use the cash method under the gross receipts test exception in all tax years subsequent to the year in which the test is not met, regardless of whether the threshold is subsequently increased by indexing above the amount of average annual gross receipts for the year in which the test was not met.

Accounting method changes under the provision are deemed to be initiated by the taxpayer and made with the consent of the Secretary. Thus, the adjustments under section 481 are spread over four years (in the case of a positive change) or taken into account entirely in one year (in the case of a negative change).

Taxpayers who are eligible to use the cash method under the provision also are exempt from maintaining inventories on the accrual method. Thus, the $1 million gross receipts threshold of Rev. Proc. 2001-10 is effectively increased to $10 million for taxpayers qualifying for the provision.

Effective Date

The provision is applicable to taxable years beginning after the date of enactment.

E. Work Opportunity Tax Credit
(sec. 104 of the bill and sec. 51 of the Code)

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

Targeted groups eligible for the credit

Generally an employer is eligible for the credit only for qualified wages paid to members of a targeted group.

(1) Families receiving TANF

An eligible recipient is an individual certified by a designated local employment agency (e.g., a State employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program ("TANF") for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

(2) Qualified veteran

A qualified veteran is a veteran who is certified by the designated local agency as a member of a family certified as receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

For these purposes, a veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(3) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law, and (2) having a hiring date within one year of release from prison or date of conviction.

(4) High risk youth

A high-risk youth is an individual certified as being at least age 18 but not yet age 25 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, or renewal community (as defined under Subchapter U of Subtitle A, Chapter 1 of the Internal Revenue Code). Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, or renewal community.

(5) Vocational rehabilitation referral

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a State plan approved under the Rehabilitation Act of 1973; or (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(6) Qualified summer youth employee

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15, (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who has not been an employee of that employer before, and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community (as defined under Subchapter U of Subtitle A, Chapter 1 of the Internal Revenue Code). As with high risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first year wages will take into account wages paid to the youth while a qualified summer youth employee.

(7) Qualified food stamp recipient

A qualified food stamp recipient is an individual aged 18 but not yet 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement

that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

(8) Qualified SSI recipient

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income ("SSI") benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

(9) Long-term family assistance recipients

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that have received family assistance for at least 18 consecutive months ending on the hiring date; (2) a member of a family that have received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit)[18] if the individual is hired within two years after the date that the 18-month total is reached; or (3) a member of a family who are no longer eligible for family assistance because of either Federal or State time limits, if the individual is hired within two years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally wages are defined by reference to the FUTA definition of wages contained in sec. 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

Calculation of the credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

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[18] The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of $10,000 for qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of $10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $9,000 (40 percent of the first $10,000 of qualified first-year wages plus 50 percent of the first $10,000 of qualified second-year wages).

Certification rules

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration

The work opportunity tax credit is not available for individuals who begin work for an employer after December 31, 2007.

Reasons for Change

The Committee believes that the experience with the credit has been positive and wishes to extend and expand the credit. In particular, the Committee believes that the credit can be used

to improve employment opportunities for broader classes of qualified veterans and designated community residents. Also, the Committee believes that the expansion of the vocational rehabilitation referral group appropriately conforms availability of the credit to a previous expansion of the vocational rehabilitation referral program. Finally, the Committee believes that a longer-term expansion will encourage greater employer participation in the credit.

Explanation of Provision

Extension

The provision extends the work opportunity tax credit for five years (for qualified individuals who begin work for an employer after December 31, 2007 and before January 1, 2013).

Qualified veterans targeted group

The provision expands the qualified veterans' targeted group to include an individual who is certified as entitled to compensation for a service-connected disability incurred after September 10, 2001. Being entitled to such compensation means having a disability rating of 10-percent or higher for service connected injuries.

Qualified first-year wages

The provision expands the definition of qualified first-year wages from $6,000 to $12,000 in the case of individuals certified as being entitled to compensation for a service-connected disability incurred after September 10, 2001 (i.e., having a disability rating of 10-percent or higher).

High risk youth targeted group

The provision expands the definition of high risk youths to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. The provision also changes the name of the category to the "designated community residents" targeted group.

Vocational rehabilitation referral targeted group

The provision expands the definition of vocational rehabilitation referral to include any individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing, an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act.

Effective Date

Generally, the extension of the credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2007. The other provisions are

effective for individuals who begin work for an employer after the date of enactment in taxable years ending after such date.

F. Treatment of Professional Employer Organizations as Employers for Employment Tax Purposes (sec. 105 of the bill and new secs. 3511 and 7705 of the Code)

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the taxes under the Railroad Retirement Tax Act ("RRTA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[19]

FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base for the calendar year ($97,500 for 2007). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

RRTA taxes consist of tier 1 taxes and tier 2 taxes. Tier 1 taxes parallel the OASDI and HI taxes applicable to employers and employees. Tier 2 taxes consist of employer and employee taxes on railroad compensation up to the tier 2 wage base for the calendar year. For 2007, the tier 2 employer rate is 12.1 percent, the employee rate is 3.9 percent, and the tier 2 wage base is $72,600.

Under FUTA, employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions means payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees' remuneration.[20]

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[19] Secs. 3101-3128 (FICA), 3201-3241 (RRTA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

[20] The "SUTA Dumping Prevention Act of 2004" (Pub. L. No. 108-295), set standards for State law to prevent the practice of "SUTA dumping," a tax evasion scheme where shell companies are formed to obtain low State unemployment insurance tax rates.

Employers are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Wages paid to employees, and FICA, RRTA, and income taxes withheld from the wages, are required to be reported on employment tax returns and on Forms W-2.[21]

Employment taxes generally apply to all remuneration paid by an employer to an employee. However, various exclusions apply to certain types of remuneration or certain types of services, which may depend on the type of employer for whom an employee performs services.[22] For example, remuneration (subject to a dollar limit) paid to an employee by a tax-exempt organization is excluded from wages for FICA purposes, and services performed in the employ of certain tax-exempt organizations are excluded from employment for FUTA purposes.[23] In addition, various definitions and special rules apply to certain types of employers.[24]

As discussed above, certain employment taxes apply only on amounts up to a specified wage base. If an employee works for multiple employers during a year, separate wage bases generally apply to each employer. However, a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base applies in certain cases in which an employer (a "successor" employer) takes over the business of another employer (the "predecessor" employer) and employs the employees of the predecessor employer.

Responsibility for employment tax compliance

Employment tax responsibility generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[25] Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances. The test of whether

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[21] Secs. 6011 and 6051.

[22] See, e.g., secs. 3121(a) and (b), 3231(e), 3306(b) and (c), and 3401(a).

[23] Secs. 3121(a)(16) and 3306(c)(8).

[24] See, e.g., secs. 3121, 3122, 3125, 3126, 3127, 3231, 3306, 3308, 3309, 3401(a), 3404, 3506, and 3510.

[25] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

an employer-employee relationship exists often arises in determining whether a worker is an employee or an independent contractor. However, the same test applies in determining whether a worker is an employee of one person or another.[26]

In some cases, a person other than the common-law employer (a "third party") may be liable for employment taxes. For example, if wages are paid to an employee by a third party and the third party, rather than the employer, has control of the payment of the wages, the third party is the statutory employer responsible for complying with applicable employment tax requirements.[27] In addition, certain designated agents are jointly and severally liable with the employer for employment taxes with respect to wages paid to the employer's employees. These designated agents prepare and file employment tax returns using their own name and employer identification number. In contrast, reporting agents (often referred to as payroll service providers) are generally not liable for the employment taxes reported on their clients' returns. Reporting agents prepare and file employment tax returns for their clients using the client's name and employer identification number.

Professional employer organizations

A professional employer organization (sometimes called an employee leasing company) provides employees to perform services in the businesses of the professional employer organization's customers, generally small and medium-sized businesses. In many cases, before the professional employer organization arrangement is entered into, the employees already work in the customer's business as employees of the customer. The terms of a typical professional employer organization agreement provide that the professional employer organization is responsible for paying the employees and for the related employment tax compliance. Legally, the employees may be the employees of the customer, rather than the professional employer

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[26] Issues relating to the classification of workers as employees or independent contractors are discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, at Vol. II, Part XV.A, at 539-550.

[27] Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the employee's share of FICA from wages); *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA). The mere fact that wages are paid by a person other than the employer does not necessarily mean that the payor has control of the payment of the wages. Rather, control depends on the facts and circumstances. See, e.g., *Consolidated Flooring Services v. United States*, 38 Fed. Cl. 450 (1997), and *Winstead v. United States*, 109 F. 2d 989 (4th Cir. 1997).

organization; nonetheless, customers typically rely on the professional employer organization to satisfy employment tax obligations.[28]

Income tax credits based on wages for employment tax purposes

The Code provides various income tax credits to employers under which the amount of the credit is determined by reference to the amount of wages for employment tax purposes.[29] For example, the amount of an employer's work opportunity credit is based on a portion of FUTA wages paid by the employer to employees who are members of certain targeted groups.[30] In addition, the credit for employer FICA tax paid on tips is based on the employer share of FICA tax paid by the employer with respect to certain tips treated as wages for FICA purposes.[31]

Reporting by large food and beverage establishments

Certain reporting requirements relating to tips apply to large food or beverage establishments.[32] In the case of such an establishment, an employer is generally required to report the following information to the IRS each calendar year: (1) the gross receipts of the establishment from the provision of food and beverages (other than certain receipts); (2) the aggregate amount of charge receipts (other than certain receipts); (3) the aggregate amount of charged tips on the charge receipts; (4) the sum of the aggregate amount of tips reported to the employer by employees and certain amounts required to be reported by the employer on employees' Form W-2s; and (5) with respect to each employee, the amount of tips allocated to the employee based on the receipts of the establishment. The employer must also provide employees with written statements showing certain information each calendar year, including the amount of tips allocated to the employee for the year.

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[28] As discussed in the text above, the issue of whether a worker is an employee of a particular entity for employment tax purposes is generally determined by reference to section 3121(d), which incorporates the common law definition of employee. This common law definition also generally applies for purposes of who is an employee for retirement plan purposes. In some cases, a professional employer organization may provide benefits to workers who are legally the employees of the customer. The IRS has issued guidance with respect to how the retirement plan rules apply in such cases. For example, Revenue Procedure 2002-11, 2002-1 C.B. 911, provides that employees of a customer may be covered under a multiple employer defined contribution plan of the professional employer organization if the customer adopts the plan and certain other requirements are satisfied. See also Rev. Proc. 2003-86, 2003-2 C.B. 1211.

[29] See, e.g., secs. 41 (credit for research expenses), 45A (Indian employment credit), 45B (credit for employer FICA tax paid on tips), 45C (credit for clinical drug testing expenses), 51 (work opportunity credit), 51A (welfare-to-work credit), 1396 (empowerment zone employment credit), 1400(d) (DC Zone employment credit), and 1400H (renewal community employment credit).

[30] Sec. 51(c)(1).

[31] Sec. 45B(b)(1).

[32] Sec. 6053(c).

User fees

User fees apply to requests to the IRS for ruling letters, opinion letters, determination letters, and similar requests.[33] The user fees that apply are determined by the IRS and are generally required to be determined after taking into account the average time and difficulty involved in a request.

Reasons for Change

The IRS estimates that the portion of tax gap attributable to FICA and FUTA taxes is $15 billion.[34] An additional portion of the tax gap is attributable to income taxes due on unreported wages.

Professional employer organizations specialize in providing employees and employment-related services, including employment tax compliance, to their customers, which are generally small and medium-sized businesses. In addition, a professional employer organization can obtain economies of scale not available to its individual customers. As a result, professional employer organizations may improve employment tax compliance.

Under present law, responsibility for employment tax compliance generally rests with the employer. Uncertainty may exist as to whether a professional employer organization or its customer is the employer of the employees provided to the customer, making it unclear which party bears employment tax responsibility. In the case of noncompliance, the IRS may have difficulty establishing either party's liability for unpaid employment taxes. The Committee believes that improved employment tax compliance can be achieved by providing rules under which a professional employer organization that meets certain standards and follows certain procedures is treated for employment tax purposes as the employer of employees provided to customers, and thus is responsible for employment tax compliance, rather than the customers.

Explanation of Provision

Treatment of certified professional employer organization as employer for employment tax purposes

Under the provision, if certain requirements are met, solely for purposes of employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of any work site employee performing services for any customer of the certified professional employer organization, but only with respect to remuneration remitted to the work site employee by the certified professional employer organization. In addition, no other person is treated as the employer for employment tax

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[33] Sec. 7528.

[34] Internal Revenue Service, *IRS Updates Tax Gap Estimates,* IR-2006-28, and attachment (Feb. 14, 2006). The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely.

purposes with respect to remuneration remitted by the certified professional employer organization to a work site employee.

Under the provision, if an individual (other than a self-employed individual) who is not a work site employee, but who performs services under a contract that meets the contract requirements applicable to work site employees, then, solely for purposes of a certified professional employer organization's liability for employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of the individual, but only with respect to remuneration remitted to the individual by the certified professional employer organization.

Under the provision, exclusions, definitions, and special rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the provision continue to apply. Thus, for example, if services performed in the employ of a customer that is a tax-exempt organization would be excluded from employment for FUTA purposes, the fact that a certified professional employer organization is treated as the employer for employment tax purposes does not affect the application of the exclusion. Similarly, if remuneration for agricultural labor[35] or for catching fish[36] would not be subject to FICA taxes, the application of the exclusion is not affected by the fact that a certified professional employer organization is treated as the employer for employment tax purposes under the provision.

The provision provides rules under which, on entering into a service contract with a customer with respect to a work site employee, a certified professional employer organization is treated as a successor employer and the customer is treated as the predecessor employer. Similarly, on termination of a service contract with respect to a worksite employee, the customer is treated as a successor employer and the certified professional employer organization is treated as a predecessor employer. Thus, wages paid by the customer and the certified professional employer organization to a work site employee during a calendar year are subject to a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base.

The provision does not apply in the case of a customer who is related to the certified professional employer organization.[37] In addition, an individual with net earnings from self-employment derived from a customer's trade or business (i.e., a self-employed individual), including a customer who is a sole proprietor or a partner of a customer that is a partnership, is not a work site employee for employment tax purposes with respect to remuneration paid by a certified professional employer organization.

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[35] See sec. 3121(a)(8).

[36] See sec. 3121(b)(20).

[37] Whether a customer and a certified professional employer organization are related is determined under the rules of section 267(b) (relating to transactions between related taxpayers) or 707(b) (relating to transactions between a partner and partnership). However, rules based on more than 50 percent ownership are applied by substituting 10 percent for 50 percent.

A certified professional employer organization is eligible for the FUTA credit with respect to contributions made to a State unemployment fund with respect to a work site employee by the certified professional employer organization or a customer. An additional FUTA credit may be claimed by a certified professional employer organization if, under State law, a certified professional employer organization is permitted to collect and remit contributions with respect to a work site employee to the State unemployment fund.

Certified professional employer organization

A certified professional employer organization is a person who has been certified by the Secretary, for purposes of being treated as the employer for employment tax purposes under the provision, as meeting certain requirements. These requirements are met if the person--

- demonstrates that the person (and any owner, officer, and such other persons as may be specified in regulations) meets requirements established by the Secretary with respect to tax status, background, experience, business location, and annual financial audits;
- computes its taxable income using an accrual method of accounting unless the Secretary approves another method;
- agrees to satisfy the bond and independent financial review requirements (described below) on an ongoing basis;
- agrees to satisfy any reporting obligations imposed by the Secretary;
- agrees to verify on such periodic basis as prescribed by the Secretary that it continues to meet the requirements for certification; and
- agrees to notify the Secretary in writing within such time as prescribed by the Secretary of any change that materially affects whether it continues to meet the requirements for certification.

Under the bond requirement, a certified professional employer organization must post a bond for the payment of employment taxes in a minimum amount and in a form acceptable to the Secretary. The minimum amount is determined for the period April 1 of any calendar year through March 31 of the following calendar year and is the greater of (1) five percent of the employment taxes for which the certified professional employer organization is liable under the provision during the preceding calendar year (but not to exceed $1,000,000), or (2) $50,000.

Under the independent financial review requirements, a certified professional employer organization must: (1) have, as of the most recent review date (i.e., six months after the completion of the certified professional employer organization's fiscal year), caused to be prepared and provided to the Secretary an opinion of an independent certified public accountant that the certified professional employer organization's financial statements are presented fairly in accordance with generally accepted accounting principles; and (2) provide to the Secretary, not later than the last day of the second month beginning after the end of each calendar quarter, from an independent certified public accountant an assertion regarding Federal employment tax payments and an examination level attestation on the assertion. The assertion must state that the certified professional employer organization has withheld and made deposits of all required

FICA, RRTA, and withheld income taxes for the calendar quarter, and the attestation must state that the assertion is fairly stated in all material respects. If a certified professional employer organization fails to file the required assertion and attestation with respect to any calendar quarter, the independent financial review requirements are treated as not satisfied for the period beginning on the due date for the attestation.

For purposes of the bond and independent financial review requirements, all professional employer organizations that are members of a controlled group of corporations or under common control are treated as a single organization.[38] The Secretary may suspend or revoke the certification of a person's certified professional employer organization status if the Secretary determines that the person does not satisfy the representations or other requirements for certification or fails to satisfy the applicable accounting, reporting, payment, or deposit requirements.

Work site employee

A work site employee is an individual who: (1) performs services for a customer of a certified professional employer organization pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements (described below); and (2) performs services at a work site meeting certain requirements (described below).[39] Thus, if the contract or work site fails to meet applicable requirements, the individual is not a work site employee.

The contract between the customer and the certified professional employer organization must be in writing and, with respect to an individual performing services for the customer, must provide that the certified professional employer organization will--

- assume responsibility for payment of wages to the individual, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for reporting, withholding, and paying any employment taxes with respect to the individual's wages, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for any employee benefits that the contract may require the certified professional employer organization to provide, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for hiring, firing, and recruiting workers in addition to the customer's responsibility for hiring, firing and recruiting workers;
- maintain employee records relating to the individual; and

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[38] Whether entities are members of a controlled group of corporations or under common control is determined under the rules of section 414(b) and (c).

[39] As discussed above, a self-employed individual is not a work site employee.

- agree to be treated as a certified professional employer organization for employment tax purposes with respect to such individual.

For purposes of whether an individual is a work site employee, the work site where the individual performs services meets the applicable requirements if at least 85 percent of the individuals performing services for the customer at the work site are subject to one or more contracts with the certified professional employer organization that meet the above requirements.[40]

Regulations

The Secretary of Treasury ("Secretary") is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision. The Secretary is also directed to develop reporting and recordkeeping rules, regulations, and procedures to ensure compliance with the provision with respect to entities applying for and receiving certification as certified professional employer organizations. These are to be designed in a manner to streamline, to the extent possible, the application of the requirements of the provision, the exchange of information between a certified professional employer organization and its customers, and the reporting and recordkeeping obligations of a certified professional employer organization.

No inference with respect to other provisions

Nothing contained in the provision or the amendments made by the provision is to be construed to create any inference with respect to the determination of who is an employee or employer (1) for Federal tax purposes (other than the purposes set forth in the provision), or (2) for purposes of any other provision of law.

Other rules

Income tax credits based on wages for employment tax purposes

Under the provision, for purposes of various income tax credits[41] under which the amount of the credit is determined by reference to the amount of employment tax wages or employment taxes: (1) the credit with respect to a worksite employee performing services for a customer applies to the customer (not to the certified professional employer organization); (2) the customer (and not the certified professional employer organization) is to take into account wages

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[40] For this purpose, excluded employees under section 414(q)(5), such as employees who are under age 21 or have not completed six months of service, are not taken into account.

[41] Secs. 41 (credit for research expenses), 45A (Indian employment credit), 45B (credit for employer FICA tax paid on tips), 45C (credit for clinical drug testing expenses), 51 (work opportunity credit), 51A (welfare-to-work credit), 1396 (empowerment zone employment credit), 1400(d) (DC Zone employment credit), 1400H (renewal community employment credit), and any other provision as provided by the Secretary.

and employment taxes paid by the certified professional employer organization with respect to the worksite employee and for which the certified professional employer organization receives payment from the customer; and (3) the certified professional employer organization is required to furnish the customer with any information necessary for the customer to claim the credit.[42]

Reporting by large food and beverage establishments

Under the provision, if a certified professional employer organization is treated for employment tax purposes as the employer of a work site employee, the customer for whom the work site employee performs services is the employer for purposes of the reporting required with respect to a large food or beverage establishment. The certified professional employer organization is required to furnish the customer with any information necessary to complete the required reporting.

User fees

Under the provision, the user fee charged under the program for certifying a professional employer organization may not exceed $500.

Effective Date

The provision is effective with respect to wages paid for services performed on or after January 1 of the first calendar year beginning more than 12 months after the date of enactment of the provision. The Secretary is directed to establish the certification program for professional employer organizations not later than six months before the provision becomes effective.

[42] Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income (sec. 199). The deduction for a taxable year is limited to 50 percent of the wages deducted in arriving at qualified production activities income. To be taken into account, wages must be paid by the taxpayer to its employees and reported on Form W-2. For this purpose, wages means wages subject to income tax withholding, as well as elective deferrals and certain other amounts. Under regulations dealing with wages paid by an entity other than the common-law employer, a taxpayer may take into account wages paid by another entity and reported by the other entity on Form W-2 (with the other entity listed as the employer on the Form W-2), provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. Treas. Reg. sec. 1.199-2(a)(2). The provision does not affect the application of these rules.

G. Subchapter S Provisions
(secs. 111-116 of the bill and secs. 1361 and 1362 of the Code)

Overview

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

Reasons for Change

Many small businesses are organized as S corporations. The bill contains a number of provisions relating to these corporations. These provisions modernize the S corporation rules and eliminate undue restrictions on S corporations. The Committee believes that these changes will improve the operation of Subchapter S and therefore will benefit small businesses.

1. Capital gain not treated as passive investment income

Present Law

Passive investment income

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, gain or loss from any section 1256 contract (or related property) of an options or commodities dealer, or certain interest and dividend income of banks and depository institution of holding companies.

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

Explanation of Provision

The provision eliminates gains from sales or exchanges of stock or securities as an item of passive investment income.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

2. Treatment of bank director shares

Present Law

An S corporation may have no more than 100 shareholders and may have only one outstanding class of stock.

An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.[43]

National banking law requires that a director of a national bank own stock in the bank and that a bank have at least five directors.[44] A number of States have similar requirements for State-chartered banks. In some cases, a bank director enters into an agreement under which the bank (or a holding company) will reacquire the stock upon the director's ceasing to hold the office of director, at the price paid by the director for the stock.[45]

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[43] Sec. 1361(c)(4). Treasury regulations provide that buy-sell and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of, or below, the fair market value of the stock. Treas. Reg. sec. 1.1361-1(l).

[44] 12 U.S.C. secs. 71-72.

[45] See Private Letter Ruling 200217048 (January 24, 2002) describing such an agreement and holding that it creates a second class of stock. Nonetheless, the ruling concluded that the election to be an S corporation was inadvertently invalid and that an amended agreement did not create a second class of stock so that the corporation's election was validated.

Explanation of Provision

Under the provision, restricted bank director stock is not taken into account as outstanding stock in applying the provisions of subchapter S.[46] Thus, the stock is not treated as a second class of stock; a director is not treated as a shareholder of the S corporation by reason of the stock; the stock is disregarded in allocating items of income, loss, etc. among the shareholders; and the stock is not treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary.

Restricted bank director stock is stock in a bank (as defined in sec. 581), or a depository institution holding company (within the meaning of sec. 3(w)(1) of the Federal Deposit Insurance Act), if the stock is required to be held by an individual under applicable Federal or State law in order to permit the individual to serve as a director of the bank or holding company and which is subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder is required to sell the stock back upon ceasing to be a director at the same price the individual acquired the stock.

A distribution (other than a payment in exchange for the stock) with respect to the restricted stock is includible in the gross income of the director and is deductible by the S corporation for the taxable year that includes the last day of the director's taxable year in which the distribution is included in income.

Effective Date

The provision applies to taxable years beginning after December 31, 2006.

The provision also provides that restricted bank director stock is not treated as a second class of stock for taxable years beginning after December 31, 1996.

3. Treatment of banks changing from reserve method of accounting

Present Law

A financial institution which uses the reserve method of accounting for bad debts may not elect to be an S corporation.[47] If a financial institution changes from the reserve method of accounting, there is taken into account for the taxable year of the change adjustments to taxable income necessary to prevent amounts from being duplicated or omitted by reason of the change.[48]

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[46] No inference is intended as to the proper income tax treatment of restricted bank director stock or other similar stock under present law.

[47] Sec. 1361(b)(2)(A).

[48] Sec. 481.

Positive adjustments (i.e., additions to taxable income) are generally spread over four taxable years beginning in the year of change.[49] Negative adjustments (i.e., reductions to taxable income) are generally taken into account entirely in the year of change.[50]

In the case of a financial institution that changes from the reserve method and elects to be an S corporation for the year of change, the adjustments are both included in the income of the shareholders and are taken into account in computing the tax on built-in gain under section 1374. If the change in accounting method is made for the last taxable year prior to becoming an S corporation, any adjustments for that year are taken into account in computing the corporation's taxable income, but not taken into account by the shareholders.

Explanation of Provision

The provision allows a bank which changes from the reserve method of accounting for bad debts for its first taxable year for which it is an S corporation to elect to take into account all adjustments under section 481 by reason of the change in the last taxable year it was a C corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 2006.

4. Treatment of sale of an interest in a qualified subchapter S subsidiary

Present Law

Under present law, an S corporation that owns all the stock of a corporation may elect to treat the subsidiary corporation as a qualified subchapter S subsidiary ("QSub"). A qualified subchapter S subsidiary is disregarded as a separate entity for Federal tax purposes and its items of income, deduction, loss, and credit are treated as items of the S corporation.

If the subsidiary corporation ceases to be a QSub (e.g., fails to meet the wholly-owned requirement) the subsidiary is treated as a new corporation acquiring all its assets (and assuming all of its liabilities) immediately before such cessation from the parent S corporation in exchange for its stock. Under Treasury regulations,[51] the tax treatment of the termination of the QSub election is determined under general principals of tax law, including the step transaction doctrine. The regulations set forth an example[52] in which an S corporation sells 21 percent of the stock of a QSub to an unrelated party. In the example, the deemed transfer of all the assets to the

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[49] Rev. Proc. 2002-19, 2002-1 C.B. 696.

[50] Id.

[51] Treas. Reg. sec. 1.1361-5(b).

[52] Example 1 of Treas. Reg. sec. 1.1361-5(b)(3).

QSub is treated as a taxable sale because the S corporation was not in control of the QSub immediately after the transfer by reason of the sale, and thus the transfer did not qualify for nonrecognition treatment under section 351.

Explanation of Provision

The provision provides that where the sale of stock of a QSub results in the termination of the QSub election, the sale is treated as a sale of an undivided interest in the assets of the QSub (based on the percentage of the stock sold) followed by a deemed transfer to the QSub in a transaction to which section 351 applies.

Thus, in the above example, the S corporation will be treated as selling a 21 percent-interest in all the assets of the QSub to the unrelated party, followed by a transfer of all the assets to a new corporation in a transaction to which section 351 applies. Thus, the S corporation will recognize 21 percent of the gain or loss in the assets of the QSub.

Effective Date

The provision applies to taxable years beginning after December 31. 2006.

5. Elimination of earnings and profits attributable to pre-1983 years

Present Law

The Small Business Jobs Protection Act of 1996 provided that if a corporation was an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of that year were reduced by the accumulated earnings and profits (if any) accumulated in a taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S.

Explanation of Provision

The provision provides in the case of any corporation which was not an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of the first taxable year beginning after the date of the enactment of this provision is reduced by the accumulated earnings and profits (if any) accumulated in a taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

6. Expansion of qualifying beneficiaries of an electing small business trust

Present Law

Under present law, an electing small business trust ("ESBT") may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a potential current beneficiary of an ESBT.

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and is generally taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers (currently 35 percent). This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Explanation of Provision

The provision allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Effective Date

The provision is effective on the date of enactment.

TITLE II − REVENUE PROVISIONS

A. Modification of Effective Date of Leasing Provisions of the American Jobs Creation Act of 2004 (sec. 201 of the bill and sec. 470 of the Code)

Present Law

Present law provides for the deferral of losses attributable to certain tax exempt use property, generally effective for leases entered into after March 12, 2004. The deferral provision does not apply to property located in the United States that is subject to a lease with respect to which a formal application: (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004; (2) is approved by the Federal Transit Administration before January 1, 2006; and (3) includes a description and the fair market value of such property (the "qualified transportation property exception").

Reasons for Change

The Committee is aware that certain leasing transactions entered into with foreign lessees prior to March 12, 2004 are continuing to provide a benefit to the taxpayers who participated in such transactions. The Committee finds these transactions and their continuing benefit to be inappropriate. Thus, the provision denies any future tax benefit with respect to the transactions.

Explanation of Provision

The provision changes the effective date of the loss deferral rules with respect to certain leases. Under the provision, the loss deferral rules also apply to leases entered into on or before March 12, 2004, if the lessee is a foreign person or entity. With respect to such leases, losses are deferred starting in taxable years beginning after December 31, 2006.

No inference is intended with respect to the tax treatment of leases entered into on or before March 12, 2004, if the lessee is not a foreign person or entity.

Effective Date

The provision is effective as if included in the provisions of the American Jobs Creation Act of 2004 to which it relates.

B. Tax Treatment of Certain Inverted Corporate Entities (sec. 202 of the bill and sec. 7874 of the Code)

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. Other corporations (i.e., those incorporated under the laws of foreign countries or U.S. possessions) generally are treated as foreign.

U.S. taxation of domestic corporations

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the double taxation that may arise from taxing the foreign-source income of a domestic corporation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether such income is repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected

by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions prior to the American Jobs Creation Act of 2004

Prior to the American Jobs Creation Act of 2004 ("AJCA"), a U.S. corporation could reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions were commonly referred to as inversion transactions. Inversion transactions could take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions were stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion could be used to reach a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction could be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation could transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from U.S. taxing jurisdiction, the corporate group could seek to derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This could include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure could enable the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

Inversion transactions could give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognized gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value had declined, and/or it had many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" was reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also could give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under secs. 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings could be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognized gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally did not recognize gain or loss, assuming the transaction met the requirements of a reorganization under section 368.

U.S. tax treatment of inversion transactions under AJCA

In general

AJCA added new section 7874 to the Code, which defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan[53] or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion ("80-percent inversion") by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[54]

In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded, with the result that the transaction would not meet the definition of an inversion under the provision. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

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[53] Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

[54] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is to provide regulations to carry out the provision, including regulations to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary has the authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

Transactions involving at least 60 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

Other rules

Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" rules apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

Reasons for Change

The Committee believes that the inversions regime should generally apply to companies that completed 80-percent inversion transactions after public notice was given that eventual legislation on this issue could be effective after March 20, 2002.

Explanation of Provision

The provision generally extends the 80-percent inversion regime of section 7874 to 80-percent inversions completed after March 20, 2002 but on or before March 4, 2003, with certain modifications as described below. A transaction otherwise meeting the definition of an 80-percent inversion under the provision (i.e., one completed after March 20, 2002 but on or before March 4, 2003) is not treated as an 80-percent inversion if, on or before March 20, 2002, the foreign-incorporated entity had acquired directly or indirectly more than half the properties held directly or indirectly by the domestic corporation, or more than half the properties constituting the partnership trade or business, as the case may be.

Under the provision, an 80-percent inversion that is completed after March 20, 2002 but on or before March 4, 2003 is respected until the end of the last day of the foreign-incorporated entity's taxable year that began in 2006. At the end of that day, the inverted foreign-incorporated entity that completed the 80-percent inversion (or if relevant, any successor entity) is deemed to have transferred all of its assets and liabilities to a domestic corporation in a transaction that is generally treated as a nontaxable inbound reorganization ("repatriation"). The basis of the assets of the foreign-incorporated entity generally remains the same in the hands of the domestic corporation, subject to any special adjustments for importing built-in losses (e.g., sec. 362(e)). Shareholders of the domestic corporation inherit the respective bases of their shares of the foreign-incorporated entity.

On the day of the repatriation, the earnings and profits of the inverted foreign-incorporated entity transfer over to the domestic corporation. The transfer of such earnings and profits is not a deemed dividend and does not result in a tax upon the domestic corporation or its shareholders. In addition, any foreign taxes attributable to such earnings and profits are not creditable. However, shareholders may be subject to tax on distributions of such earnings and profits.

Beginning on the day after the repatriation, the inverted foreign-incorporated entity is treated for all tax purposes as a domestic corporation. Thus, any income earned by the inverted foreign-incorporated entity after the date of repatriation is deemed to be earned by a domestic corporation, and therefore, is fully taxable at U.S. corporate income tax rates. As a further consequence of the repatriation of the inverted foreign-incorporated entity, foreign subsidiaries become controlled foreign corporations, subject to the rules of subpart F.

It is intended that the Secretary will prescribe regulations that are necessary or appropriate to carry out the provision, including, but not limited to, regulations to prevent the avoidance of the purposes of the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006.

C. Denial of Deduction for Punitive Damages (sec. 203 of the bill and sec. 162(g) of the Code)

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[55] However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[56] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[57] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[58]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[59] However, this exclusion does not apply to punitive damages.[60]

Reasons for Change

The Committee believes that allowing a tax deduction for punitive damages undermines the societal role of punitive damages in discouraging and penalizing the activities or actions for which punitive damages are imposed. If a taxpayer deducts a payment for punitive damages, the amount of the payment does not reflect the true after-tax punitive effect on the taxpayer. The Committee is concerned that allowing a deduction for such payments in effect shifts a portion of the penalty to the Federal Government and to the public. Furthermore, the Committee believes that determining the amount of punitive damages to be disallowed as a tax deduction is not administratively burdensome because taxpayers generally can make such a determination readily by reference to pleadings filed with a court, and plaintiffs already make such a determination in determining the taxable portion of any payment. The Committee also believes that reporting the amount of any insurance payment for punitive damages to the IRS and the taxpayer will promote effective tax administration and foster compliance with the tax laws.

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[55] Sec. 162(a).

[56] Sec. 162(c).

[57] Sec. 162(f).

[58] Sec. 162(g).

[59] Sec. 104(a).

[60] Sec. 104(a)(2).

Explanation of Provision

The provision denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

Effective Date

The provision is effective for punitive damages that are paid or incurred on or after the date of enactment.

D. Denial of Deduction for Certain Fines, Penalties, and Other Amounts (sec. 204 of the bill and sec. 162 of the Code)

Present Law

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[61]

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Reasons for Change

The Committee is concerned that there is a lack of clarity and consistency under present law regarding when taxpayers may deduct payments made in settlement of government investigations of potential wrongdoing, as well as in situations where there has been a final determination of wrongdoing. If a taxpayer deducts payments made in settlement of an investigation of potential wrongdoing or as a result of a finding of wrongdoing, the publicly announced amount of the settlement payment does not reflect the true after-tax penalty on the taxpayer.[62] The Committee also is concerned that allowing a deduction for such payments in effect shifts a portion of the penalty to the Federal government and to the public. The Committee believes that reporting the payments to the IRS and the taxpayer promotes effective tax administration and fosters compliance with the tax law.

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[61] S. Rep. No. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

[62] The Government Accountability Office ("GAO") reported that the majority of companies responding to a GAO survey deducted civil settlement payments when their settlement agreements did not label the payments as penalties. See, Government Accountability Office, *TAX ADMINISTRATION: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments,* (GAO-05-747).

Explanation of Provision

The provision modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the provision generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law [63] are nondeductible under any provision of the income tax provisions.[64] The provision applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property), or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, and that are identified in the court order or settlement as restitution, remediation, or required to come into compliance.[65] The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made.[66]

An exception also applies to any amount paid or incurred as taxes due.[67]

The provision is intended to apply only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law.[68]

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[63] The provision does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the provision would affect that payment.

[64] The provision provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

[65] The provision does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which continue to be governed by the provisions of section 162(g).

[66] If a settlement agreement does not specify a specific amount to be paid for the purpose of coming into compliance but instead simply requires the taxpayer to come into compliance, it is sufficient identification to so state. Amounts expended by the taxpayer for that purpose would then be considered identified. However, if an agreement specifies a specific dollar amount that must be paid or incurred, the amount would not be eligible to be deducted without a specification that it is for restitution (including remediation of property), or coming into compliance.

[67] Thus, amounts paid or incurred as taxes due are not affected by the provision (e.g., State taxes that are otherwise deductible). The reference to taxes due is also intended to include interest with respect to such taxes (but not interest, if any, with respect to any penalties imposed with respect to such taxes).

[68] Thus, for example, the provision would not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a

It is intended that a payment will be treated as restitution (including remediation of property) only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution or included remediation of property.[69] Restitution and included remediation of property is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution and included remediation of property includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution or included remediation of property does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

It is intended that a payment will be treated as an amount required to come into compliance only if it directly corrects a violation with respect to a particular requirement of law that was under investigation. For example, if the law requires a particular emission standard to be met or particular machinery to be used, amounts required to be paid under a settlement agreement to meet the required standard or install the machinery are deductible to the extent otherwise allowed. Similarly, if the law requires certain practices and procedures to be followed and a settlement agreement requires the taxpayer to pay to establish such practices or procedures, such amounts would be deductible. However, amounts paid for other purposes not directly correcting a violation of law are not deductible. For example, amounts paid to bring other machinery that is already in compliance up to a standard higher than required by the law, or to create other benefits (such as a park or other action not previously required by law), are not deductible if required under a settlement agreement. Similarly, amounts paid to educate consumers or customers about the risks of doing business with the taxpayer or about the field in which the taxpayer does business generally, which education efforts are not specifically required under the law, are not deductible if required under a settlement agreement.

The provision requires government agencies to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered where the aggregate amount required to be paid or incurred to or at the direction of the government under such settlement agreements and orders with respect to the violation, investigation, or inquiry is least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The reports must be made within 30 days of the date the court order is issued or the settlement agreement is entered into, or such other time as

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court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause a payment to be made "at the direction of a government" for purposes of the provision.

[69] Similarly, a payment to a charitable organization benefiting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the provision, such a payment not deductible under section 162 would also not be deductible under section 170.

may be required by Secretary. The report must separately identify any amounts that are restitution or remediation of property, or correction of noncompliance.[70]

The IRS is encouraged to require taxpayers to identify separately on their tax returns the amounts of any such settlements with respect to which reporting is required under the provision, including separate identification of the nondeductible amount and of any amount deductible as restitution, remediation, or required to correct noncompliance.[71]

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are paid or incurred for restitution, remediation of property, or coming into compliance and that are identified as such in the order or settlement agreement likewise applies in these cases. The requirement of reporting to the IRS and the taxpayer also applies in these cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the provision is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

Effective Date

The provision is effective for amounts paid or incurred on or after the date of enactment; however the provision does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained before the date of enactment.

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[70] As in the case of the identification requirement, if the agreement does not specify a specific amount to be expended to come into compliance but simply requires that to occur, it is expected that the report may state simply that the taxpayer is required to come into compliance but no specific dollar amount has been specified for that purpose in the settlement agreement.

[71] For example, the IRS might require such separate reporting as part of, or in addition to, reporting of amounts that are not deducted and that thus create a book tax difference on the schedule M-3.

E. Revision of Tax Rules on Expatriation of Individuals (sec. 205 of the bill and secs. 102, 877, 2107, 2501, 7701 and 6039G of the Code)

Present Law

In general

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States), but excluding intangibles, such as stock, regardless of where they are located.

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. long-term residency, unless certain conditions are met, the individual is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax for the 10-year period at the rates applicable to U.S. citizens, but only on U.S.-source income.[72]

A "long-term resident" is a noncitizen who is a lawful permanent resident of the United States for at least eight taxable years during the period of 15 taxable years ending with the taxable year during which the individual either ceases to be a lawful permanent resident of the United States or commences to be treated as a resident of a foreign country under a tax treaty between such foreign country and the United States (and does not waive such benefits).

A former citizen or former long-term resident is subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for certain dual citizens and minors who have had no substantial contacts with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

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[72] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

Estate tax rules with respect to expatriates

Special estate tax rules apply to individuals who die during a taxable year in which he or she is subject to the alternative tax regime. Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets. The special rules apply if, at the time of death: (1) the former citizen or former long-term resident directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then the gross estate of the former citizen or former long-term resident includes that proportion of the fair market value of the foreign stock owned by the individual at the time of death, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of death) bears to the total fair market value of all assets owned by such foreign corporation (at the time of death).

Gift tax rules with respect to expatriates

Special gift tax rules apply to individuals who make gifts during a taxable year in which he or she is subject to the alternative tax regime. The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination. In addition, gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident are subject to gift tax, if the gift is made during the time that such person is subject to the alternative tax regime. The operative rules with respect to these gifts of closely-held foreign stock are the same as described above relating to the estate tax, except that the relevant testing and valuation date is the date of gift rather than the date of death.

Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes

An individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement to the Secretary of the Treasury in accordance with section 6039G.

Sanction for individuals subject to the individual tax regime who return to the United States for extended periods

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and, therefore, is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes[73] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[74] and individuals with minimal prior physical presence in the United States,[75] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

Annual return

Former citizens and former long-term residents are required to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate and gift tax rules.

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[73] Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

[74] An individual has such a relationship to a foreign country if (1) the individual becomes a citizen or resident of the country in which the individual was born, such individual's spouse was born, or either of the individual's parents was born, and (2) the individual becomes fully liable for income tax in such country.

[75] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, for purposes of this test, an individual is not treated as being present in the United States on a day if the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $10,000. The $10,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

Immigration rules with respect to expatriates

Under U.S. immigration laws, any former U.S. citizen who officially renounces his or her U.S. citizenship and who is determined by the Attorney General to have renounced for the purpose of U.S. tax avoidance is ineligible to receive a U.S. visa and will be denied entry into the United States. This provision was included as an amendment (the "Reed amendment") to immigration legislation that was enacted in 1996.

Reasons for Change

The Committee is aware that some individuals each year relinquish their U.S. citizenship or terminate their U.S. residency for the purpose of avoiding U.S. income, estate, and gift taxes. By so doing, such individuals reduce their annual U.S. income tax liability and reduce or eliminate their U.S. estate and gift tax liability.

The Committee recognizes that citizens and residents of the United States have a right not only physically to leave the United States to live elsewhere, but also to relinquish their citizenship or terminate their residency. The Committee does not believe that the Internal Revenue Code should be used to stop U.S. citizens and residents from relinquishing citizenship or terminating residency; however, the Committee also does not believe that the Code should provide a tax incentive for doing so. In other words, to the extent possible, an individual's decision to relinquish citizenship or terminate residency should be tax-neutral.

The Committee recognizes that the American Jobs Creation Act of 2004 altered prior law regarding expatriation in a number of respects, including the replacement of the subjective "principal purpose of tax avoidance test" with objective rules. Notwithstanding these changes, the Committee remains concerned that the present-law expatriation tax rules (as modified in 2004) are difficult to administer and could be made more effective. In addition, the Committee is concerned that the alternative method of taxation under section 877 can be avoided by postponing the realization of U.S.-source income for 10 years.

Consequently, the Committee believes that the present-law expatriation tax rules should be replaced with a new tax regime applicable to former citizens and residents. Because U.S. citizens and residents who retain their citizenship or residency generally are subject to income tax on accrued appreciation when they dispose of their assets, as well as estate tax on the full value of assets that are held until death, the Committee believes it fair to tax individuals on the appreciation in their assets when they relinquish their citizenship or terminate their residency. The Committee believes that an exception from such a tax should be provided for individuals with a relatively modest amount of appreciated assets. The Committee also believes that, where U.S. estate or gift taxes are avoided with respect to a transfer of property to a U.S. person by reason of the expatriation of the donor, it is appropriate for the recipient to be subject to an income tax based on the value of the property.

The Committee also believes that the present-law immigration rules applicable to former citizens are ineffective. The Committee believes that the rules should be modified to eliminate the requirement of proof of a tax avoidance purpose, and to coordinate the application of those rules with the tax rules provided under the new regime.

Explanation of Provision

In general

The provision generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination ("mark-to-market tax"). Gain from the deemed sale is taken into account at that time without regard to other Code provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code, except that the wash sale rules of section 1091 do not apply. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 per covered expatriate. The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2007.

Individuals covered

The mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency (collectively, "covered expatriates"). The definition of "long-term resident" under the provision is the same as that under present law. As under present law, an individual is considered to terminate long-term residency when the individual either ceases to be a lawful permanent resident (i.e., loses his or her green card status), or is treated as a resident of another country under a tax treaty and does not waive the benefits of the treaty.

Exceptions to an individual's classification as a covered expatriate are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18½, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

For purposes of the mark-to-market tax, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

In addition, the provision provides that, for all tax purposes (i.e., not limited to the mark-to-market tax), a U.S. citizen continues to be treated as a U.S. citizen for tax purposes until that individual's citizenship is treated as relinquished under the rules of the immediately preceding paragraph. However, under Treasury regulations, relinquishment may occur earlier with respect to an individual who became at birth a citizen of the United Sates and of another country.

Election to be treated as a U.S. citizen

Under the provision, a covered expatriate is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an "all or nothing" election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, applies to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, following expatriation the individual continues to pay U.S. income taxes at the rates applicable to U.S. citizens on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property continues to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer is required to waive any treaty rights that would preclude the collection of the tax.

The individual is also required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) becomes a lien in favor of the United States on all U.S.-situated property owned by the individual. This lien arises on the expatriation date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary of the Treasury is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Deemed sale of property upon expatriation or residency termination and tentative tax

The deemed sale rule of the provision generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests (which remain subject to U.S. tax in the hands of nonresident noncitizens), with the exception of stock of certain former U.S. real property holding corporations, are exempted from the provision. Regulatory authority is granted to the Treasury to exempt other types of property from the provision.

Under the provision, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquishes citizenship or terminates residency. Thus, the tentative tax is based on all income, gains, deductions, losses, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. Moreover, notwithstanding any other provision of the Code, any period during which recognition of income

or gain had been deferred terminates on the day before relinquishment of citizenship or termination of residency (and, therefore, such income or gain recognition becomes part of the tax base of the tentative tax). The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency, subject to the election, described below, to defer payments of the mark-to-market tax. In addition, notwithstanding any other provision of the Code, any extension of time for payment of tax ceases to apply on the day before relinquishment of citizenship or termination of residency, and the unpaid portion of such tax becomes due and payable at the time and in the manner prescribed by the Secretary of the Treasury.

Deferral of payment of mark-to-market tax

Under the provision, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. The election is irrevocable and is made on a property-by-property basis. Under the election, the deferred tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in a transaction in which gain is not recognized in whole or in part, at such other time as the Secretary of the Treasury may prescribe). The deferred tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax as the gain taken into account with respect to such property bears to the total gain taken into account under these rules. The deferral of the mark-to-market tax may not be extended beyond the due date of the return for the taxable year which includes the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide a bond in the amount of the deferred tax to the Secretary of the Treasury. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred tax amount (including any interest, penalties, and certain other items) becomes a lien in favor of the United States on all U.S.-situated property owned by the individual. This lien arises on the expatriation date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to such liens.

Retirement plans and similar arrangements

Subject to certain exceptions, the provision applies to all property interests held by covered expatriates at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored qualified plan or

deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).[76] However, the provision contains a special rule for an interest in a "retirement plan." For purposes of the provision, a "retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), an individual retirement account (sec. 408(a)), and an individual retirement annuity (sec. 408(b)). The special retirement plan rule also applies, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a retirement plan is subject to the special retirement plan rules and not to the rules for interests in trusts (discussed below).

Under the special retirement plan rules, in lieu of the deemed sale rule, an amount equal to the present value of the individual's vested, accrued benefit under a retirement plan is treated as having been received by the individual as a distribution under the retirement plan on the day before the individual's relinquishment of citizenship or termination of residency. In the case of any later distribution to the individual from the retirement plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule, over (2) the total reductions applied to any prior distributions. It is not intended that the retirement plan would be deemed to have made a distribution at the time of expatriation for purposes of the tax-favored status of the retirement plan, such as whether a plan may permit distributions before a participant has severed employment. However, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

Interests in trusts

In general

Detailed rules apply under the provision to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a "qualified trust." A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

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[76] Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts

If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets for their fair market value on the day before the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. Any income, gain, or loss of the individual arising from the deemed distribution from the trust is taken into account as if it had arisen under the deemed sale rules.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, historical patterns of trust distributions, and the existence of, and function performed by, a trust protector or any similar advisor.

Qualified trusts

If an individual has an interest in a qualified trust, the amount of mark-to-market tax on unrealized gain allocable to the individual's trust interest ("allocable expatriation gain") is calculated at the time of expatriation or residency termination, but is collected as the individual receives distributions from the qualified trust. The allocable expatriation gain is the amount of gain which would be allocable to the individual's trust interest if the individual directly held all the assets allocable to such interest.[77] If any individual's interest in a trust is vested as of the day before the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive).

[77] Allocable expatriation gain is subject to the $600,000 exemption (adjusted for cost of living increases).

Taxes are imposed on each distribution from a qualified trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates for the taxable year which includes the date of expatriation, but in no event will the tax imposed exceed the balance in the "deferred tax account" with respect to the trust interest. For this purpose, the balance in the deferred tax account is equal to (1) the hypothetical tax calculated under the "regular" deemed sale rules with respect to the allocable expatriation gain, (2) increased by interest charged on the balance in the deferred tax account at a rate two percentage points higher than the rate normally applicable to individual underpayments, for periods beginning after the 90th day after the expatriation date and calculated up to 30 days prior to the date of the distribution, (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual, and (4) to the extent provided in Treasury regulations, in the case of a covered expatriate holding a nonvested interest, reduced by mark-to-market taxes imposed on trust distributions to other persons holding nonvested interests.

The tax that is imposed on distributions from a qualified trust generally is to be deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax.

Mark-to-market taxes become due immediately if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the balance in the deferred tax account with respect to the trust interest immediately before that date. Such tax is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual (or his or her estate) with respect to such tax.

Regulatory authority

The provision authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision. In addition, the Secretary of the Treasury may provide for adjustments to the bases of assets in a trust or a deferred tax account, and the timing of such adjustments, to ensure that gain is taxed only once.

Income tax treatment of gifts and inheritances from a former citizen or former long-term resident

Under the provision, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a covered expatriate. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient takes a basis in the property equal to that value. The tax does not apply to property that is shown on a timely

filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return was filed, but no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be.

Coordination with present-law alternative tax regime

The provision provides a coordination rule with the present-law alternative tax regime. Under the provision, the present-law expatriation income tax rules under section 877, and the special present-law expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (generally described above), do not apply to a covered expatriate whose expatriation or residency termination occurs on or after the date of enactment.

Information reporting

Certain information reporting requirements under the law presently applicable to former citizens and former long-term residents (sec. 6039G) also apply for purposes of the provision.

Immigration rules

The provision amends the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the provision's expatriation tax provisions (regardless of the subjective motive for expatriating). For this purpose, the provision permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the provision permits the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with the new tax rules, and to identify the items of any noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection apply to return information disclosed under this provision.

Effective Date

The provision generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of enactment. The due date for tentative tax, however, may not occur before the 90th day after the date of enactment. The portion of the provision relating to income taxes on gifts and inheritances is effective for gifts and inheritances received from former citizens or former long-term residents (or their estates) on or after the date of enactment, whose relinquishment of citizenship or residency termination occurs after such date. The portion of the provision relating to immigration and disclosure with respect to former citizens is effective with respect to individuals who relinquish citizenship on or after the date of enactment.

F. Limit Amounts of Annual Deferrals Under Nonqualified Deferred Compensation Plans (sec. 206 of the bill and sec. 409A of the Code)

Present Law

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.[78] The requirements include rules relating to distributions, acceleration of benefits and funding. For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. In general, elections to defer compensation for a taxable year must be made not later than the close of the preceding taxable year. Section 409A does not include rules limiting the amount that may be deferred under a nonqualified deferred compensation plan.

A nonqualified deferred compensation plan generally includes any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) and an eligible deferred compensation plan (sec. 457(b)) is a qualified employer plan.

If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Under present law, Treasury is authorized to prescribe regulations as are necessary or appropriate to carry out the purposes of the provision.

Reasons for Change

The Committee is concerned with the large amount of executive compensation that is deferred in order to avoid the payment of income taxes. Rank and file employees generally do not have the opportunity to defer taxation on otherwise includible income in excess of the qualified plan limits. However, it is common for nonqualified deferred compensation arrangements to allow executives to choose the amount of income inclusion they wish to defer.[79]

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[78] Code sec. 409A.

[79] *See, e.g.*, Ellen E. Schultz and Theo Francis, *As Workers' Pensions Wither, Those for Executives Flourish*, WALL ST. J., June 23, 2006, at A1, and *Deferring Compensation Also Creates A Company Debt to Executives*, June 23, 2006, at A8. Theo Francis, '*Phantom' Accounts for CEOs Draw Scrutiny*, WALL ST. J., June 13, 2005, at B1.

The Committee is concerned that the ability to defer unlimited amounts of compensation gives executives more control over the timing of income inclusion than rank and file employees. The Committee believes that the amount of compensation that can be deferred to avoid the payment of tax should be limited.

Explanation of Provision

The provision adds an additional requirement to the rules governing the income inclusion of amounts deferred under a nonqualified deferred compensation plan. Under the provision, the annual aggregate amounts deferred under a nonqualified deferred compensation plan by an individual may not exceed the applicable dollar amount for the taxable year. The applicable dollar amount is the lesser of (1) $1 million or (2) the average annual compensation payable during the base period to the participant by the employer maintaining the nonqualified deferred compensation plan (or a predecessor or related entity) and which was includible in the participant's gross income for taxable years in the base period. Earnings (whether actual or notional) attributable to nonqualified deferred compensation are treated as additional deferred compensation and are subject to the provision. Thus, such amounts are taken into account in determining whether the limit on the amount deferred is exceeded.

If the requirement is not satisfied, the present-law sanctions for failure to satisfy section 409A apply. Thus, if the requirement is not satisfied, all amounts deferred under the nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If the requirements of the provision are not satisfied, as under present law, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.[80]

Earnings (whether actual or notional) in a subsequent taxable year on amounts included in income under the provision are includible in income in such subsequent taxable year to the extent such earnings are not subject to a substantial risk of forfeiture and not previously included in gross income. The present-law sanctions under 409A (interest at the underpayment rate plus one percentage point and a 20-percent additional tax) also apply.

The base period is the five taxable year period ending with the taxable year preceding the taxable year for which the limitation is being determined (the "computation year"). If, before the beginning of the computation year, an election is made to defer compensation for services performed in the computation year, the base period is the five taxable year period ending with the taxable year preceding the taxable year in which the election is made. For example, suppose an executive elects in 2008 to defer a portion of compensation to be earned in 2009. The base

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[80] These consequences apply under the provision to amounts deferred after the effective date of the provision.

period for the 2009 computation year would be 2003 to 2007. In the case that the individual does not perform services for the employer for the entire five-year period, the base period is the portion of such period during which the individual performs services for the employer (or a predecessor employer). It is intended that the Secretary of Treasury issue guidance similar to that under section 280G regarding the base period determination in cases in which the individual does not perform services for the employer for the entire five-year period.

As under section 409A generally, except as provided by the Secretary, aggregation rules similar to the rules under section 414(b) and (c) apply. In addition, all nonqualified deferred compensation plans maintained by all employers treated as a single employer under these aggregation rules are treated as one plan.

The provision applies to all amounts deferred under nonqualified deferred compensation plans (as defined under section 409A), including plans of both private and publicly-held corporations.

As under section 409A generally, this limitation is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The regulatory authority of the Secretary of the Treasury to prescribe regulations as are necessary to carry out the purposes of section 409A generally applies to the provision. Under such existing regulatory authority, it is expected that the Secretary of the Treasury will issue guidance relating to defined benefit arrangements, including the application of the annual limitation and determination of the amounts deferred.

Effective Date

The provision applies to taxable years beginning after December 31, 2006, with respect to amounts deferred after such date (and earnings on such amounts). Amounts deferred (and earnings on amounts deferred) in taxable years beginning before January 1, 2007, are not subject to the provision. Taxable years beginning on or before December 31, 2006, are taken into account in determining the average annual compensation of a participant during any base period.

The provision directs the Secretary of the Treasury, within 60 days after enactment, to issue guidance providing a limited time period during which a nonqualified deferred compensation plan adopted before December 31, 2006, may, without violating the requirements of section 409A, be amended to provide that a participant may, no later than December 31, 2007, cancel or modify an outstanding deferral election with regard to all or a portion of amounts deferred after December 31, 2006, to the extent necessary to meet the requirements of the provision. Amounts subject to the cancellation or modification are currently includible in income to the participant to the extent not subject to a substantial risk of forfeiture and not previously included in income. Such guidance must also allow nonqualified deferred compensation plans adopted before December 31, 2006, to be amended to conform to the requirements of the provision with regard to amounts deferred after December 31, 2006.

G. Increase in Criminal Monetary Penalty Limitation for the Underpayment or Overpayment of Tax Due to Fraud (sec. 207 of the bill and secs. 7201, 7203, and 7206 of the Code)

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code and who willfully fail to do so. Upon conviction, the Code provides that the penalty is up to $25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision; (b) for a felony,[81] $250,000 for an individual or $500,000 for an organization; or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code.[82] For example, for an individual, the maximum

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[81] Section 7206 states that making fraudulent or false statements under the Code is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. 3559(a)(5).

[82] In *United States v. Booker*, 543 U.S. 220 (2005), the Supreme Court held that mandatory application of the Federal Sentencing Guidelines is incompatible with the Sixth Amendment jury trial requirement. As a result of this decision, the Federal Sentencing Guidelines are effectively advisory, i.e., requiring a sentencing court to consider the sentencing ranges under the Guidelines, but permitting it to tailor a sentence in light of other statutory concerns.

fine under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

Reasons for Change

The Committee believes that existing criminal tax penalties do not adequately deter criminal behavior, which results in increased noncompliance and an increase in the tax gap. Increasing monetary penalties will raise the economic risk of failing to comply with tax laws. In addition, classifying certain willful failure to file cases as felonies should discourage criminal tax violations by substantially increasing the monetary and sentencing consequences of the offense together with the long term repercussions associated with a felony record.

Explanation of Provision

Attempt to evade or defeat tax

The provision increases the criminal penalty under section 7201 of the Code for individuals to $500,000 and for corporations to $1,000,000. The provision increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The provision increases the criminal penalty under section 7203 of the Code for individuals from $25,000 to $50,000 and, in the case of an "aggravated failure to file" (defined as a failure to file a return for a period of three or more consecutive taxable years if the aggregated tax liability for such period is at least $100,000), changes the crime from a misdemeanor to a felony and increases the maximum prison sentence to ten years.

Fraud and false statements

The provision increases the criminal penalty for making fraudulent or false statements to $500,000 for individuals and $1,000,000 for corporations. The provision increases the maximum prison sentence for making fraudulent or false statements to five years. The provision provides that in no event shall the amount of the monetary penalty under the provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective Date

The provision is effective for actions and failures to act occurring after the date of enactment.

H. Doubling of Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements (sec. 208 of the bill)

Present Law

In general

The Code contains numerous civil penalties, such as the delinquency, accuracy-related, fraud, and assessable penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the respective statutes of limitations for assessment and collection.

Delinquency penalties

Failure to file

Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. In the case of fraudulent failure to file, the penalty is increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 75 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay

Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If an income tax return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of $100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax

The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the

underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before earlier of 10 days after the date of the first delinquency notice to the taxpayer and 10 days after the date on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

Accuracy-related penalties

In general

The accuracy-related penalties are imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant part, to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, and (4) any reportable transaction understatement. The penalty for a substantial valuation misstatement is doubled for certain gross valuation misstatements. In the case of a reportable transaction understatement for which the transaction is not disclosed, the penalty rate is 30 percent. These penalties are coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith, and in the case of a reportable transaction understatement the relevant facts of the transaction have been disclosed, there is or was substantial authority for the taxpayer's treatment of such transaction, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

Negligence or disregard for the rules or regulations

If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence means any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless, or intentional disregard of the rules or regulations.

Substantial understatement of income tax

Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year, or (2) $5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement

A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Reportable transaction understatement

A penalty applies to any item that is attributable to any listed transaction, or to any reportable transaction (other than a listed transaction) if a significant purpose of such reportable transaction is tax avoidance or evasion.

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not to apply to any portion of an underpayment on which the fraud penalty is imposed.

Assessable penalties

In addition to the penalties described above, the Code imposes a number of additional penalties, including, for example, penalties for failure to file (or untimely filing of) information returns with respect to foreign trusts, and penalties for failure to disclose any required information with respect to a reportable transaction.

Interest provisions

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative ("OVCI") to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in the OVCI, including sending a written request to participate in the program by April 15, 2003. This request

had to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. A taxpayer entering into a closing agreement under the OVCI is not liable for the civil fraud penalty, the fraudulent failure to file penalty, or the civil information return penalties. Such a taxpayer is responsible for back taxes, interest, and certain accuracy-related and delinquency penalties.[83]

Voluntary disclosure policy

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.[84] The IRS treats participation in the OVCI as a voluntary disclosure.[85]

Reasons for Change

The Committee is aware that individuals and corporations, through sophisticated transactions, are placing unreported income in offshore financial accounts accessed through credit or debit cards or other financial arrangements in order to avoid or evade Federal income tax. Such a phenomenon poses a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system. The IRS estimates there may be several hundred thousand taxpayers using offshore financial arrangements to conceal taxable income from the IRS, potentially costing the government billions of dollars in lost revenue. On February 10, 2004, the IRS announced that over 1,300 applications to participate in the OVCI initiative were received, and that it had received over $175 million in taxes, interest, and penalties from these cases.[86] At the start of the program, the clear message to taxpayers was that those who failed to come forward would be pursued by the IRS and would be subject to more significant penalties and possible criminal sanctions. The Committee believes that doubling the civil penalties, fines, and interest applicable to taxpayers who participate in these types of arrangements and who do not voluntarily disclose such arrangements (through the OVCI or otherwise) will provide the IRS with the significant sanctions needed to stem the promotion of, and participation in, these abusive schemes.

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[83] Rev. Proc. 2003-11, 2003-4 C.B. 311.

[84] Internal Revenue News Release 2002-135, IR-2002-135 (December 11, 2002).

[85] Rev. Proc. 2003-11, 2003-4 C.B. 311.

[86] Internal Revenue News Release 2004-19, IR-2002-19 (February 10, 2004).

Explanation of Provision

The provision doubles the amounts of civil penalties, interest, and fines related to taxpayers' underpayments of U.S. income tax liability through the direct or indirect use of certain offshore financial arrangements. The provision applies to taxpayers who did not (or do not) voluntarily disclose such arrangements through the OVCI or otherwise. Under the provision, the determination of whether any civil penalty is to be applied to such underpayment is made without regard to whether a return has been filed, whether there was reasonable cause for such underpayment, and whether the taxpayer acted in good faith.

The proscribed financial arrangements include, but are not limited to, the use of certain foreign leasing corporations for providing domestic employee services,[87] certain arrangements whereby the taxpayer may hold securities trading accounts through offshore banks or other financial intermediaries, certain arrangements whereby the taxpayer may access funds through the use of offshore credit, debit, or charge cards, and offshore annuities or trusts.

The Secretary of the Treasury is granted the authority to waive the application of the provision if the use of the offshore financial arrangements is incidental to the transaction and, in the case of a trade or business, such use is conducted in the ordinary course of the type of trade or business in which the taxpayer is engaged.

Effective Date

The provision generally is effective with respect to a taxpayer's open tax years on or after the date of enactment.

[87] These arrangements were described and classified as listed transactions in Notice 2003-22, 2003-1 C.B. 851.

I. Increase in Penalty for Bad Checks and Money Orders (sec. 209 of the bill and sec. 6657 of the Code)

Present Law

The Code[88] imposes a penalty on a person who tenders a bad check or money orders. The penalty is two percent of the amount of the bad check or money order. For checks or money orders that are less than $750, the minimum penalty is $15 (or, if less, the amount of the check or money order).

Reasons for Change

The Committee believes that it is appropriate to increase the minimum amount of this penalty so that it is more consistent with amounts charged by the private sector for bad checks.

Explanation of Provision

The provision increases the minimum penalty to $25 (or, if less, the amount of the check or money order), applicable to checks or money orders that are less than $1,250.

Effective Date

The provision is effective with respect to checks or money orders received after the date of enactment.

[88] Sec. 6657.

J. Treatment of Contingent Payment Convertible Debt Instruments (sec. 210 of the bill and sec. 1275 of the Code)

Present Law

Under present law, a taxpayer generally deducts the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. In the case of original issue discount ("OID"), the issuer of a debt instrument generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the OID may not be paid until the maturity of the instrument. The holder of the instrument includes the OID in income over the term of the instrument.

The amount of OID with respect to a debt instrument is equal to the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts that are payable on the debt instrument by maturity. The amount of OID with respect to a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased or decreased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting any payments on the debt instrument (other than non-OID stated interest) during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a particular period, the stated redemption price at maturity and the time of maturity must be known. Issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holders of such instruments accrue and include in gross income the amount of OID as interest income.

Treasury regulations provide special rules for determining the amount of OID allocated to a period with respect to certain debt instruments that provide for one or more contingent payments of principal or interest.[89] The regulations provide that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt.[90] The regulations also provide that a payment is not a contingent payment merely because of a contingency that, as of the issue date of the debt instrument, is either remote or incidental.[91]

In the case of contingent payment debt instruments that are issued for money or publicly traded property,[92] the regulations provide that interest on a debt instrument must be taken into

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[89] Treas. reg. sec. 1.1275-4.

[90] Treas. reg. sec. 1.1275-4(a)(4).

[91] Treas. reg. sec. 1.1275-4(a)(5).

[92] Treas. reg. sec. 1.1275-4(b).

account (as OID) whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of OID that is taken into account for each accrual period is determined by constructing a comparable yield and a projected payment schedule for the debt instrument, and then accruing the OID on the basis of the comparable yield and projected payment schedule by applying rules similar to those for accruing OID on a noncontingent debt instrument (the "noncontingent bond method"). If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference. The comparable yield for a debt instrument is the yield at which the issuer would be able to issue a fixed-rate noncontingent debt instrument with terms and conditions similar to those of the contingent payment debt instrument (i.e., the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.[93]

With respect to certain debt instruments that are convertible into the common stock of the issuer and that also provide for contingent payments (other than the conversion feature) -- often referred to as "contingent convertible" debt instruments -- the IRS has stated that the noncontingent bond method applies in computing the accrual of OID on the debt instrument.[94] In applying the noncontingent bond method, the IRS has stated that the comparable yield for a contingent convertible debt instrument is determined by reference to a comparable fixed-rate nonconvertible debt instrument, and the projected payment schedule is determined by treating the issuer stock received upon a conversion of the debt instrument as a contingent payment.

Reasons for Change

The Committee is aware that, in recent years, several corporate taxpayers have issued convertible debt instruments that also include a separate contingent feature, usually consisting of an interest rate reset provision. The Committee understands that the primary intent of these corporations is simply to issue straight convertible debt instruments, and that the contingency is unlikely to have any meaningful impact on either the stated interest rate or overall economic yield of the debt instrument. Rather, the contingency is incorporated into the financing for the purpose of subjecting the debt instrument to the contingent payment OID regulations, which would not otherwise apply solely on the basis of the conversion feature. As with straight convertible debt instruments, the stated interest rate on contingent payment convertible debt instruments typically is substantially less than the stated interest rate would be on a nonconvertible debt instrument, usually less than 400 basis points.

The Committee is aware that, in determining the comparable yield on contingent payment convertible debt instruments under the contingent payment OID regulations, borrowers and their advisors take the position that the regulations call for using a comparable noncontingent debt instrument that is also nonconvertible. The net effect of applying the contingent payment OID regulations in this manner (i.e., determining the comparable yield on the basis of a noncontingent, nonconvertible -- rather than noncontingent, convertible -- debt instrument), is to

[93] Treas. Reg. sec. 1.1275-4(b)(4)(i)(A).

[94] Rev. Rul. 2002-31, 2002-1 C.B. 1023.

significantly and artificially enhance the interest deductions generated by what is essentially a straight convertible debt instrument. Because the corresponding interest income inclusions to holders of these debt instruments likewise is significantly and artificially enhanced, the Committee understands that the debt instruments almost exclusively are sold to and purchased by tax indifferent holders.

Notwithstanding the endorsement of the taxpayer position by the IRS in Rev. Rul. 2002-31, the Committee believes that applying the contingent payment OID regulations in this manner is inappropriate, from an economic standpoint and based upon a reasonable interpretation of the plain meaning of the regulations. Furthermore, applying the regulations in this manner creates disparate tax treatment between contingent payment convertible debt instruments and straight convertible debt instruments that differ only on the basis of an economically meaningless contingency.

The Committee believes that the methodology mandated by this provision would require the comparable yield on a contingent payment convertible debt instrument to be based upon a truly comparable noncontingent debt instrument (i.e., one that is convertible, like the actual debt instrument issued by the taxpayer). This methodology would provide parity between straight convertible debt instruments and contingent payment convertible debt instruments, and eliminate the unwarranted tax benefits that are currently attained merely by incorporating an essentially meaningless contingency into an otherwise ordinary convertible debt instrument.

In its ruling, the IRS indicated that determining the comparable yield on contingent payment convertible debt instruments based upon a contingent nonconvertible debt instrument is more consistent with the overall economic rationale of the contingent payment OID regulations. However, the Committee believes that this view incorrectly assumes that the economic rationale of these regulations deviates from the rest of the OID rules -- and, for that matter, general tax principles -- in giving tax significance to a conversion feature in a debt instrument. The Committee recognizes that contingent payment convertible debt instruments highlight a potential flaw in the current tax system whereby both the Code and general tax principles typically disregard the economic yield provided by convertibility features in debt instruments. However, the Committee believes that this issue should be addressed legislatively through comprehensive reform of the tax treatment of financial products, rather than through administrative acquiescence in taxpayer self-help that is achieved using a particular financial product designed specifically to obtain a favorable tax result, particularly if that result is in conflict with the current operation of the Code and general tax principles.

Explanation of Provision

The provision provides that, in the case of a contingent convertible debt instrument,[95] any Treasury regulations which require OID to be determined by reference to the comparable yield of

[95] Under the provision, a contingent convertible debt instrument is defined as a debt instrument that: (1) is convertible into stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation; and (2) provides for contingent payments.

a noncontingent fixed-rate debt instrument shall be applied as requiring that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock. For purposes of applying the provision, the comparable yield shall be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. Thus, the noncontingent bond method in the Treasury regulations shall be applied in a manner such that the comparable yield for contingent convertible debt instruments shall be determined by reference to comparable noncontingent fixed-rate convertible (rather than nonconvertible) debt instruments.

Effective Date

The provision is effective for debt instruments issued on or after date of enactment.

K. Extension of IRS User Fees (sec. 211 of the bill and sec. 7528 of the Code)

Present Law

The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[96] These user fees are authorized by statute through September 30, 2014.

Reasons for Change

The Committee believes that it is appropriate to provide an extension of these user fees.

Explanation of Provision

The provision extends the statutory authorization for IRS user fees for two years, through September 30, 2016.

Effective Date

The provision is effective for requests made after the date of enactment.

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[96] Sec. 7528.

L. Modification of Collection Due Process Procedures for Employment Tax Liabilities (sec. 212 of the bill and sec. 6330 of the Code)

Present Law

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property. A Federal tax lien arises automatically when (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial collection due process ("CDP") hearing before levy may be made on any property or right to property.[97] Similar rules apply with respect to notices of tax liens, although the right to a hearing arises only on the filing of a notice.[98] The CDP hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. Under present law, taxpayers are not entitled to a pre-levy CDP hearing if a levy is issued to collect a Federal tax liability from a State tax refund or if collection of the Federal tax is in jeopardy. However, levies related to State tax refunds or jeopardy determinations are subject to post-levy review through the CDP hearing process.

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and the requirement that employers withhold income taxes from wages paid to employees ("income tax withholding").[99] Income tax withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Reasons for Change

Congress enacted the CDP hearing procedures to afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property. However, the Committee understands that some taxpayers abuse the CDP procedures by raising frivolous arguments simply for the purpose of delaying or evading collection of tax. The opportunity to delay collection of employment tax liabilities presents a greater risk to the

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[97] Sec. 6330(a).

[98] Sec. 6320.

[99] Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). FICA taxes consist of an employer share and an employee share, which the employer withholds from employees' wages.

government than delay may present in other contexts because employment tax liabilities continue to increase as ongoing wage payments are made to employees. A Governmental Accountability Office study found that businesses with employment tax liabilities were delinquent on more than twice as many periods than individuals. On average, businesses requesting a CDP appeal for delinquent employment taxes had not paid for nearly 1½ years and had a median employment tax liability of $30,000.[100] Thus, the Committee believes it is appropriate to revise the CDP procedures in cases where taxpayers are liable for unpaid employment taxes.

Explanation of Provision

Under the provision, levies issued to collect Federal employment taxes are excepted from the pre-levy CDP hearing requirement. Thus, under the provision, taxpayers have no right to a CDP hearing before a levy is issued to collect employment taxes. However, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy. Collection by levy is permitted to continue during the CDP proceedings.

Effective Date

The provision is effective for levies issued on or after the date that is 120 days after the date of enactment.

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[100] Government Accountability Office, *Tax Administration: Little Evidence of Procedural Errors in Collection Due Process Appeals Cases, but Opportunities Exist to Improve the Program,* GAO-07-112, October 2006.

M. Whistleblower Reforms
(sec. 213 of the bill and sec. 7623 of the Code)

Present Law

The Code authorizes the IRS to pay such sums as deemed necessary for: "(1) detecting underpayments of tax; and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same."[101] Generally, amounts are paid based on a percentage of tax, fines, and penalties (but not interest) actually collected based on the information provided.

The Tax Relief and Health Care Act of 2006 (the "Act")[102] established an enhanced reward program for actions in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $2,000,000 and, if the taxpayer is an individual, the individual's gross income exceeds $200,000 for any taxable year. The reward floor in such cases is 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS's attention by an individual. The available reward in such cases is limited to 30 percent of the collected proceeds.

Under present law, the Secretary is required to issue guidance within one year of the date of enactment of the Act for the establishment of the Whistleblower Office within the IRS to administer the reward program. The Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract.

The Act permits an individual to appeal the amount or a denial of an award determination to the United States Tax Court (the "Tax Court") within 30 days of such determination. Tax Court review of an award determination may be assigned to a special trial judge.

The Act also required the Secretary to conduct a study and report to Congress on the effectiveness of the whistleblower reward program and any legislative or administrative recommendations regarding the administration of the program.

Reasons for Change

A recent report by the Treasury Inspector General for Tax Administration concluded that the IRS's informant reward program has been an effective method of identifying and collecting

[101] Sec. 7623.

[102] Pub. L. No. 109-432.

unpaid taxes.[103] The report made several recommendations for enhancing the effectiveness of the program, including centralizing management of the reward program and reducing the processing time for claims. The Act enhanced the reward program by establishing a minimum reward for certain cases and requiring the Secretary to establish a centralized office. The Committee believes that further enhancements to the reward program would make the program more attractive to future informants wishing to report violations of the tax laws. The Committee also believes that enhancements to the program will provide assurance that informants' claims are not lost, overlooked or forgotten, and that award amounts are determined in a consistent and equitable manner.

Explanation of Provision

The provision modifies the reward program established under the Act. Under the provision, this reward program applies to any actions in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $20,000 and, if the taxpayer is an individual, the individual's gross income exceeds $200,000 for any taxable year.

The provision also establishes the Whistleblower Office under the Code, rather than pursuant to regulation as provided in the Act. Although recognizing that many functions of the IRS may be involved in evaluating or otherwise addressing an informant's claim, the Congress intends that one office within the IRS ultimately is responsible and accountable for monitoring informant claims for reward and determining the amounts to be rewarded. This will ensure that all claims are considered and that awards are issued in a consistent, timely and equitable manner.

In addition, the provision requires the Secretary to report to Congress within six months of the date of enactment on the implementation of this provision, including the operation of the Whistleblower Office and the implementation of the recommendations of the Treasury Inspector General for Tax Administration.[104]

Finally, the provision authorizes the Tax Court to adopt rules to preserve the anonymity, privacy, or confidentiality of any person that may be identified during the appeal of an award determination appeal.

Effective Date

The provision generally is effective for information provided on or after the date of enactment. The provision authorizing the Tax Court to adopt rules to preserve the anonymity, privacy, or confidentiality of any person that may be identified in the appeal of an award determination is effective as if included in section 406 of the Act.

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[103] Treasury Inspector General for Tax Administration, *The Informants' Rewards Program Needs More Centralized Management Oversight,* 2006-30-092 (June 2006).

[104] Treasury Inspector General for Tax Administration, *The Informants' Rewards Program Needs More Centralized Management Oversight,* 2006-30-092 (June 2006).

N. Expand Denial of Deduction for Certain Excessive Employee Remuneration (sec. 214 of the bill and sec. 162(m) of the Code)

Present Law

Under present law, compensation in excess of $1 million paid by a publicly-held corporation to the corporation's "covered employees" generally is not deductible.[105] Covered employees are the chief executive officer as of the close of the taxable year and the four other most highly compensated officers of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid, whether the compensation is for services as a covered employee, and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken.

Performance-based compensation is not subject to the deduction limitation and is not taken into account in determining whether other compensation exceeds $1 million. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals and with respect to which certain requirements are satisfied, including a shareholder approval requirement.[106]

Reasons for Change

The Securities and Exchange Commission recently modified the group of executives for whom compensation is required to be disclosed under the Securities Exchange Act of 1934. Given these modifications, the Committee believes that it is appropriate to delink the definition of covered employee from the Securities laws. The Committee also believes that the denial of the deduction for certain excess employee remuneration should apply to any individual who serves as the Chief Executive Officer during the year, regardless of whether that position is retained on the last day of the taxable year. Under present law, the deduction limitations for certain excess employee remuneration can be avoided by delaying payment of compensation to a year in the future in which the individual is no longer a covered employee. The Committee believes that it is appropriate to continue to treat individuals as covered employees if they had been covered employees in a preceding taxable year.

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[105] Sec. 162(m).

[106] In addition, the following types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds $1 million: (1) compensation payable on a commission basis; (2) payments to a tax-qualified retirement plan (including salary reduction contributions); and (3) amounts that are excludable from the individual's gross income (such as employer-provided health benefits). Sec. 162(m)(4).

Explanation of Provision

The provision modifies the definition of covered employee. Under the provision, covered employees include any individual who was the Chief Executive Officer of the company (or individual acting in such a capacity) at any time during the taxable year. In addition, covered employees include the four officers with the highest compensation for the year (other than the Chief Executive Officer). Under the provision, covered employees also include individuals who previously were covered employees for any preceding taxable year beginning after December 31, 2006, with respect to the corporation or any predecessor. In the case of an individual who is a covered employee after December 31, 2006, covered employees also include beneficiaries of such employees with respect to any remuneration for services performed by such employee as a covered employee (whether or not such services are performed during the taxable year in which the remuneration is paid). For example, under the provision, if the Chief Executive Officer retires in November, compensation received in the year of retirement, or paid under a deferral agreement in a succeeding year, is subject to the deduction limitations for a covered employee.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006.

II. BUDGET EFFECTS OF THE BILL

A. Committee Estimates

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the revenue provisions of the "Small Business and Work Opportunity Act of 2007" as reported.

[Insert revenue table]

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that no provisions of the bill as reported involve new or increased budget authority.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing provisions of the bill involve increased tax expenditures (see revenue table in Part A., above). The revenue-increasing provisions of the bill involve reduced tax expenditures (see revenue table in part A, above).

C. Consultation with Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office has not submitted a statement on the bill. The letter from the Congressional Budget Office has not been received, and therefore will be provided separately.

III. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the standing rules of the Senate, the Committee states that, with a majority and quorum present, the "Small Business and Work Opportunity Act of 2007," as amended, was ordered favorably reported by a voice vote on January 17, 2007.

The Committee accepted the following resolution: It is the sense of the Committee on Finance that the small business provisions should be extended beyond the dates contained in the Mark.

IV. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

Impact on individuals and businesses, personal privacy and paperwork

The bill includes provisions to extend present-law tax benefits, expand eligibility for other benefits, and update Subchapter S of the Code. The bill also includes provisions increasing certain penalties and extending IRS user fees. The bill modifies the treatment of corporate inversion transactions and individuals who expatriate, and imposes limitations on the amount of compensation which may be deducted by employers or deferred by employees under the Code. The bill includes a provision to improve employment tax compliance by providing rules under which certain professional employer organizations is treated as the employer of employees provided to customers.

The bill includes various other provisions that are not expected to impose additional administrative requirements or regulatory burdens on individuals or businesses.

The provisions of the bill do not impact personal privacy.

B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4).

The Committee has determined that the following two tax provisions of the reported bill contain Federal private sector mandates within the meaning of Public Law 104-4, the Unfunded Mandates Reform Act of 1995: (1) modifying the effective date for the application of the AJCA 2004 leasing ("SILO") provision - apply loss limitation to leases with foreign entities regardless of when the lease was entered into; and (2) tax treatment of inversion transactions. The tax provisions of the reported bill do not impose a Federal intergovernmental mandate on State, local, or tribal governments within the meaning of Public Law 104-4, the Unfunded Mandates Reform Act of 1995.

The costs required to comply with each Federal private sector mandate generally are no greater than the aggregate estimated budget effects of the provision. Benefits from the provisions include improved administration of the tax laws and a more accurate measurement of income for Federal income tax purposes.

C. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity

analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "Code") and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that have "widespread applicability" to individuals or small businesses.

V. ADDITIONAL VIEWS

ADDITIONAL VIEWS BY SENATOR KERRY

I support the majority of the provisions in the Small Business and Work Opportunity Act of 2007. I would have preferred that this package move separately rather than in tandem with a minimum wage bill. However, the reality is that we need a tax package in order to advance minimum wage legislation.

Most of the provisions are targeted and will help small businesses. For example, the provision to provide fifteen-year straight line cost recovery for qualified retail improvement will help small businesses that own their stores. However, there is one provision that I find troubling. This provision would treat professional employer organizations as employers for employment tax purposes.

The reason for including this provision is to improve compliance. I am concerned that the provision which that makes certified professional employer organizations liable for payroll taxes may not actually result in improved compliance. The Joint Committee on Taxation has estimated that this provision has a ten-year cost of $33 million. If this provision truly improved compliance, I would expect it to raise revenue.

This proposal lets the workers' real employer off the hook for payroll taxes, and creates confusion about who is an employer under labor laws. I know the language says it will not affect other laws, but as a practical matter it will. It confuses workers, who will not be able to tell who their real employer is, and it sets a bad precedent that could make it harder for workers to protect their rights under important labor laws.

I realize the Committee has reported out this provision in the past, but I believe this provision will result in unintended consequences. The Committee should review this proposal in order to address concerns that have been raised.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).