H.R. XXX
“Small Business Tax Relief Act of 2010”

July 30, 2010

I. SMALL BUSINESS TAX RELIEF

Provide small business tax relief by repealing certain information reporting requirements to corporations and to payments of property. Starting in 2012, businesses will be required to file information returns with respect to any person (including corporations) that receives $600 or more from the business in exchange for property and merchandise. Furthermore, businesses will be required to file information returns with respect to corporations that receive $600 or more in exchange for services or other determinable gains. The bill would provide relief for small businesses by repealing these requirements before they take effect. *This provision is estimated to cost $19.206 billion over 10 years.*

II. ELIMINATING TAX BREAKS FOR COMPANIES THAT SHIP JOBS OVERSEAS

Summary. The bill includes a package of provisions developed jointly by the Treasury Department, the Committee on Ways and Means and the Senate Finance Committee to eliminate $11.6 billion of tax breaks for companies that ship jobs overseas. These provisions were previously passed by the House of Representatives as part of H.R. 4213 by a vote of 241 to 181 (with 2 House Republicans joining with 239 House Democrats in support).

Rules to prevent splitting foreign tax credits from income. To prevent double taxation (i.e., full taxation by both a foreign country and by the United States on the same item of income), taxpayers are permitted to claim foreign tax credits with respect to foreign taxes paid on income earned offshore. Taxpayers have devised several techniques for splitting foreign taxes from the foreign income on which those taxes were paid. With these techniques, the foreign income remains offshore and untaxed by the United States, while the foreign taxes are currently available in the U.S. to offset U.S. tax that is due on other foreign source income. In many cases, the foreign income is permanently reinvested offshore such that it likely will never be repatriated and taxed in the U.S. This use of foreign tax credits has nothing to do with relieving double taxation. The President’s FY2011 Budget proposes to adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. The bill would adopt the President’s Budget proposal by implementing a matching rule that would suspend the recognition of foreign tax credits until the related foreign income is taken into account for U.S. tax purposes. The bill targets abusive techniques and does not affect timing differences that result from normal tax accounting differences between foreign and U.S. tax rules. The provision would apply to all “split” foreign taxes claimed by taxpayers after December 31, 2010. *This proposal is estimated to raise $4.250 billion over 10 years.*

Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions. There are certain rules that permit taxpayers to treat a stock acquisition as an asset acquisition under U.S. tax law. Taxpayers can obtain similar results by acquiring interests in entities that are treated as corporations for foreign tax purposes, but as non-corporate entities (such as partnerships) for U.S. tax purposes. These transactions ("covered asset acquisitions") result in a step-up in the basis of the assets of the acquired entity to the fair market value that was paid for the stock (or interest in the business entity). In the foreign context, this step-up usually exists only for U.S. tax purposes, and not for foreign tax purposes. As a result, depreciation for U.S. tax purposes exceeds depreciation for foreign tax purposes, such that the U.S. taxable base is lower than foreign taxable base. Because foreign taxes – and therefore foreign tax credits – are based on the foreign taxable base, there are more foreign tax credits than are necessary to avoid double tax on the U.S. tax base. Taxpayers are using these additional foreign tax credits to reduce taxes imposed on other, completely unrelated foreign income. The bill would prevent taxpayers from claiming the foreign tax credit with respect to foreign income that is never subject to U.S. taxation because of a covered asset acquisition. The provision would generally apply to transactions occurring after December 31, 2010, with special transition rules for certain transactions between unrelated parties. *This proposal is estimated to raise $3.645 billion over 10 years.*

Separate application of foreign tax credit limitation to items resourced under tax treaties. To prevent double taxation (i.e., full taxation by both a foreign country and by the United States on the same item of income), taxpayers are permitted to claim foreign tax credits with respect to foreign taxes paid on income earned offshore. To appropriately limit use of the foreign tax credit system to avoidance of double taxation, foreign tax credits are limited to the maximum amount of U.S. tax that could be imposed on the taxpayer's foreign source income (i.e., thirty-five percent (35%) of the taxpayer's foreign source income). Taxpayers have devised a technique to use the U.S. treaty network to enhance foreign tax credit utilization – well beyond what is needed to avoid double taxation – by artificially inflating foreign source income. With this technique, ownership of income-producing assets that would ordinarily be held by U.S.-based multinational companies in the United States (e.g., investments in U.S. securities) is shifted to foreign branches and disregarded entities. This income is often lightly taxed on a net basis by the foreign country, but the treaty prevails in categorizing the entire gross amount of the income generated by the U.S. assets as foreign source. This artificially inflates the taxpayer's foreign source income and allows the taxpayer to use foreign tax credits to reduce taxes on foreign source income beyond the maximum amount of U.S. tax that could be imposed on such income. This unintended tax planning technique has nothing to do with relieving double taxation. The bill respects the treaty commitment to treating such income as foreign source, but segregates the income so that it is not the basis for claiming foreign tax credits that have nothing to do with double taxation. In doing so, the bill conforms the foreign tax credit treatment of taxpayers operating abroad through foreign branches and disregarded entities to the treatment already afforded to taxpayers operating through foreign corporations. The provision would apply to taxable years beginning after the date of enactment. *This proposal is estimated to raise $250 million over 10 years.*

Limitation on the use of section 956 for foreign tax credit planning (i.e., the "hopscotch" rule). U.S.-based multinational companies typically have complex foreign structures designed to mitigate their worldwide tax expense. In many cases, these structures include companies located in low-tax jurisdictions (e.g., tax havens such as Bermuda and the Cayman Islands) in a multi-

tier chain of subsidiaries. If a foreign subsidiary with a relative high tax expense distributes a dividend up through a chain of companies, the foreign tax credit on the dividend ultimately received by the U.S. shareholder is a blend of the tax rates of each foreign subsidiary in that chain. If there is a tax-haven company in that chain, the U.S. tax due on the dividend may be significantly higher than the tax would have been if the foreign subsidiary's dividend could have simply "hopscotched" over the chain as a direct distribution to the U.S. shareholder. Affirmative use of section 956, which was originally enacted as an anti-abuse provision, readily accomplishes this "hopscotch" by deeming a dividend from a foreign subsidiary directly to the U.S. shareholder. By taking advantage of this "hopscotch" rule, the foreign tax credit on this "deemed dividend" can be greater than the foreign tax credit would be on an actual dividend. The bill would limit the amount of foreign tax credits that may be claimed with respect to a deemed dividend under section 956 to the amount that would have been allowed with respect to an actual dividend. The provision would apply to the affirmative use of section 956 after the date of December 31, 2010. *This proposal is estimated to raise $704 million over 10 years.*

Special rule with respect to certain redemptions by foreign subsidiaries. Where a foreign-based multinational company owns a U.S. company, and that U.S. company owns a foreign subsidiary, the earnings of the foreign subsidiary are generally subject to U.S. tax when they are distributed to the U.S. shareholder. When those earnings are then distributed by the U.S. company to its foreign shareholder, a thirty percent (30%) withholding tax applies, unless reduced by treaty or some other provision of the tax code. Foreign-based multinational companies have devised a technique for avoiding U.S. taxation of such foreign subsidiary earnings. This technique involves a provision of the tax code that was originally enacted as an anti-abuse rule that treats certain sales of stock between related parties as a dividend. For example, under this provision, where a foreign-based multinational corporation sells stock in the U.S. company to its foreign subsidiary, the cash received from the foreign subsidiary in this sale is treated as a dividend from that foreign subsidiary. This deemed dividend allows the foreign subsidiary's earnings to completely – and permanently – bypass the U.S. tax system. The bill would eliminate this type of tax planning by preventing the foreign subsidiary's earnings from being reduced and, as a result, the earnings would remain subject to U.S. tax (including withholding tax) when repatriated to the foreign parent corporation as a dividend. The provision would apply to acquisitions after December 31, 2010. *This proposal is estimated to raise $203 million over 10 years.*

Modification of affiliation rules for purposes of rules allocating interest expense. To prevent double taxation (i.e., full taxation by both a foreign country and by the United States on the same item of income), taxpayers are permitted to claim foreign tax credits with respect to foreign taxes paid on income earned offshore. To appropriately limit use of the foreign tax credit system to avoidance of double taxation, foreign tax credits are limited to the maximum amount of U.S. tax that could be imposed on the taxpayer's foreign source income (i.e., thirty-five percent (35%) of the taxpayer's foreign source income). Taxpayers have used various techniques to minimize the amount of foreign source interest expense, which has the effect of artificially boosting foreign source income. In turn, this permits taxpayers to utilize more foreign tax credits than would otherwise be possible, and the use of such additional foreign tax credits has nothing to do with relieving double taxation. To prevent taxpayers from avoiding these rules, Treasury regulations prevent taxpayers from excluding foreign interest expense from the foreign tax credit limitation by placing it in foreign subsidiaries. The regulations achieve this result by including certain

subsidiaries in the U.S. affiliated group. As a result, foreign source interest expense will be taken into account in the determination of the foreign tax credit limitation. The bill would modify the affiliation rules to strengthen these anti-abuse rules. The provision would apply to taxable years beginning after the date of enactment. *This proposal is estimated to raise $390 million over 10 years.*

Repeal of 80/20 rules. Under current law, dividends and interest paid by a domestic corporation are generally considered U.S.-source income to the recipient and are generally subject to gross basis withholding if paid to a foreign person. If at least eighty percent (80%) of a corporation's gross income during a three-year period is foreign source income and is attributable to the active conduct of a foreign trade or business (a so-called "80/20 company"), dividends and interest paid by the corporation will generally not be subject to the gross basis withholding rules. Furthermore, interest received from an 80/20 company can increase the foreign source inxome of, and therefore the amount of foreign tax credits that may be claimed by, a U.S. multinational company. Treasury has become aware that some companies have abused the 80/20 company rules. As a result, the President's 2011 Budget proposes to repeal these rules. The bill would adopt the President's Budget proposal to repeal the 80/20 company rules. The bill would also repeal the 80/20 rules for interest paid by resident alien individuals. The bill would include relief for existing 80/20 companies that meet specific requirements and are not abusing the 80/20 company rules. Subject to the relief for these existing 80/20 companies, the provision would apply to taxable years beginning after December 31, 2010. *This provision is estimated to raise $153 million over 10 years.*

Source rules on guarantees. Under current law, the treatment of guarantee fees under the source rules is unclear. If guarantee fees are sourced like services, they are sourced according to the location in which the services were performed. If the guarantee fees are sourced like interest, they are sourced by reference to the country of residence of the payor. A recent court case determined that guarantee fees should be sourced like services. Sourcing guarantee fees in a manner similar to services would permit U.S. subsidiaries of foreign corporations to engage in earning stripping transactions by making deductible payments to foreign affiliates (thereby reducing their U.S. income tax liability) without the imposition of U.S. withholding tax on the payment. The bill would provide that guarantees on indebtedness issued after the date of enactment will be sourced like interest and, as a result, if paid by U.S. taxpayers to foreign persons will generally be subject to withholding tax. No inference is intended with respect to the treatment of guarantees on indebtedness issued before the date of enactment. *This proposal is estimated to raise $2.000 billion over 10 years.*

Technical correction to statute of limitations provision in the HIRE Act. The bill would make a technical correction to the foreign compliance provisions of the *Hiring Incentives to Restore Employment (HIRE) Act* that would clarify the circumstances under which the statute of limitations will be tolled for corporations that fail to provide certain information on cross-border transactions or foreign assets. Under the technical correction, the statute of limitations period will not be tolled if the failure to provide such information is shown to be due to reasonable cause and not willful neglect. *This proposal is estimated to not have any revenue effect over 10 years.*

III. <u>OTHER REVENUE OFFSETS</u>

Crude tall oil ineligible for cellulosic biofuel producer credit. In 2008, Congress enacted a $1.01 per gallon tax credit for the production of biofuel from cellulosic feedstocks in order to encourage the development of new production capacity for biofuels that are not derived from food source materials. The House of Representatives has voted on numerous occasions to prevent unprocessed fuels (e.g., black liquor) from claiming this tax credit. Congress is aware that some taxpayers are seeking to claim the cellulosic biofuel tax credit for processed fuels that are highly corrosive, such as crude tall oil (another waste by-product of the paper manufacturing process). The bill would limit eligibility for the tax credit to fuels that are not highly corrosive (i.e., fuels that could be used in a car engine or in a home heating application). This provision is identical to a provision that passed the House of Representatives as part of H.R. 4849 by a vote of 246 to 178 (with 4 House Republicans joining 242 Democrats in support) and as part of H.R. 4899 by a vote of 239 to 182 (with 3 House Republicans joining 236 House Democrats in support). *This proposal is estimated to raise $1.885 billion over 10 years.*

Require a minimum 10-year term for grantor retained annuity trusts ("GRATs"). Grantor retained annuity trusts ("GRATs") allow taxpayers to structure a transfer of assets to another individual in such a way that substantial gift taxes may be avoided. A GRAT is generally an irrevocable trust in which the grantor retains an annuity interest and transfers a remainder interest to another individual. For gift tax purposes, in valuing the gift of the remainder interest to the beneficiaries of such a trust, current law allows taxpayers to deduct the value of the retained annuity interest from the value of the transferred assets. The value of the retained annuity interest is determined by computing the present value of the annuity at a statutory growth rate. If the property transferred to the trust appreciates in value at a rate that is greater than the statutory growth rate, the excess appreciation will be transferred tax free to the trust beneficiaries. One significant risk to this type of tax planning is that, if the grantor dies during the trust term, the portion of the trust necessary to satisfy the annuity amount is included in the grantor's gross estate for estate tax purposes. This generally eliminates the benefit of using a GRAT. As a result, taxpayers have created short-term GRATs to maximize their gift tax planning while minimizing the chances that they might die during the trust term. The bill would include the President's 2011 Budget proposal to require a minimum 10-year term for GRATs to significantly limit this type of planning. In connection with requiring a minimum 10-year term, the bill would also require that the value of the remainder interest must be greater than zero and that the annuity must not decrease during the first 10 years of the GRAT term. As a result, the bill would require taxpayers to take on a greater risk that they might die during the GRAT term in order to take advantage of the gift tax benefits of using a GRAT. This provision is identical to a provision that passed the House of Representatives as part of H.R. 4849 by a vote of 246 to 178 (with 4 House Republicans joining 242 House Democrats in support) and as part of H.R. 4899 by a vote of 239 to 182 (with 3 House Republicans joining 236 House Democrats in support). *This provision is estimated to raise $5.272 billion over 10 years.*

Clarification of gain recognized in certain spin-off transactions (e.g., "Reverse Morris Trust" transactions). Under current law, taxes are generally imposed on parent corporations where they extract value in excess of basis from their subsidiaries prior to engaging in a tax-free spin-off transaction. Therefore, if a subsidiary corporation distributes cash or other property to

its parent in excess of the parent's basis in the subsidiary or if a subsidiary corporation assumes parent debt in excess of the parent's basis in the subsidiary, the parent corporation will recognize gain. However, taxes are not assessed if a subsidiary corporation distributes its own debt securities to a parent corporation prior to a spin off transaction even where the value of these securities would exceed the parent corporation's basis in its subsidiary. The bill would treat distributions of debt securities in a tax-free spin-off transaction in the same manner as distributions of cash or other property. This provision is identical to a provision that passed the House of Representatives as part of H.R. 4849 by a vote of 246 to 178 (with 4 House Republicans joining 242 House Democrats in support). *This provision is estimated to raise $260 million over 10 years.*

Increase penalties for failure to file information returns. The bill increases penalties for failure to timely file information returns to the IRS. The first-tier penalty is increased from $15 to $30, and the calendar year maximum is increased from $75,000 to $250,000. The second-tier penalty is increased from $30 to $60, and the calendar year maximum is increased from $150,000 to $500,000. The third-tier penalty is increased from $50 to $100, and the calendar year maximum is increased from $250,000 to $1.5 million. For small filers, the calendar year maximum is increased from $25,000 to $75,000 for the first-tier penalty, from $50,000 to $200,000 for the second-tier penalty, and from $100,000 to $500,000 for the third-tier penalty. The minimum penalty for each failure due to intentional disregard is increased from $100 to $250. The penalty amounts are adjusted every five years for inflation. Penalties for failure to file information returns to payees are similarly increased. This provision is identical to a provision that passed the House of Representatives as part of H.R. 4994 by a vote of 399 to 9 (with 156 House Republicans joining with 243 House Democrats in support). *This provision is estimated to raise $421 million over ten years.*