EXECUTIVE COMMITTEE MEETING TO DISCUSS ORGANIZATIONAL MATTERS: COMMITTEE RULES, APPOINTMENTS TO JOINT COMMITTEE ON TAXATION, APPOINTMENTS TO CONGRESSIONAL TRADE ADVISORS ON TRADE POLICY AND NEGOTIATIONS; APPOINTMENTS TO THE CONGRESSIONAL OVERSIGHT GROUP; AND THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

WEDNESDAY, JANUARY 17, 2007

U.S. Senate,

Committee on Finance,

Washington, DC.

The meeting was convened, pursuant to notice, at 10:05 a.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Kerry, Lincoln, Wyden, Schumer, Stabenow, Cantwell, Salazar, Grassley, Hatch, Lott, Kyl, Thomas, Smith, Bunning, Crapo, and Roberts.

Also present: Eric Solomon, Assistant Secretary of the Treasury for Tax Policy, U.S. Department of Treasury; Tom Barthold, Acting Chief of Staff, Joint Committee on Taxation.

Also present: Democratic staff--Russ Sullivan, Staff Director; Mary Baker, Tax Counsel, and Rebecca Baxter, Tax Counsel. Republican staff--Kolan Davis, Staff Director and Chief Counsel; Ted Totman, Deputy Staff Director; Dean Zerbe, Tax Counsel and Senior Counsel to Senator Grassley; Carla Martin, Chief Clerk; and Mark

Blair, Deputy Clerk.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

Chairman Baucus. The meeting will come to order.

In 1788, James Madison wrote, "The power of the purse may in fact be regarded as the most complete and effectual weapon with which any constitution can arm the immediate representatives of the people for obtaining a redress of every grievance and for carrying into effect every just and salutary measure."

Since 1816, that power of the purse has lived on in this committee. In 1981, our former chairman and Majority Leader, Bob Dole, wrote, "Legislation acted on by the Committee on Finance raises virtually all of the Federal revenue. Expenditures authorized in legislation handled by the committee represent almost one-half of the Federal budget. Overall, the Committee on Finance handles legislation involving more money than any other committee in the Congress."

In the quarter century since Senator Dole wrote, the share of the people's fiscal business done by the committee has, if anything, only increased. This committee has great powers, and with that power comes great responsibilities.

The Senators who have constituted this committee

have, by tradition, chosen to exercise that power cooperatively. In the quarter century since Senator Dole wrote, the partisanship of the government has, if anything, only increased, but this committee has remained, by and large, an oasis of cooperation.

Senator Grassley and I have worked together to manage this committee. We met every Tuesday that the Senate is in session. As much as possible, we choose to make policy choices together and that cooperation will continue.

I want this committee to work together. Last Thursday, the members of this committee met in a private session to discuss today's mark-up. I listened to what members said and I think you will find that I have adjusted what we do here today in response to last week's meeting. I intend to make such meetings a regular practice in the formulation of consensus.

Tomorrow, members of this committee will meet in private session with Treasury Secretary Paulson and OMB Director Portman to discuss the Nation's fiscal policy. Next Tuesday, we will meet and do the same with Federal Chairman Bernanke. In days to come, we will conduct similar meetings with U.S. Trade Representative Schwab and HHS Secretary Leavitt.

The job of a chairman is to produce the best

legislation that a majority of votes will allow. Some chairman of other committees have also viewed it as their job to produce legislation with the thinnest majority of votes allowed. That is not the tradition of this committee and that is not how we will operate.

My goal will be to produce legislation with broad majorities. I will seek to have this committee produce legislation that will pass the Senate with 65 votes, 70 votes, or more.

I believe that legislation with such broad support is better legislation, and I will seek to have this committee produce legislation that the President will sign into law. That is what the people sent us here to do, and here we will try to do it.

So today we meet again to carry on this great tradition and to organize this committee for the 110th Congress. Let us do so in humble recognition of the great responsibilities that we bear to exercise the people's power of the purse. Let us do so in the finest tradition of working together, and let us do so in a sincere effort to get the people's business done.

I would now like to recognize Senator Grassley for any opening statement he would wish to make.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator Grassley. I welcome the opportunity for an opening statement and to say what everybody knows, that we are talking today about the tax incentives to assist workers and businesses that are burdened by an increase in Federal minimum wage.

I would, first off, thank Chairman Baucus for recognizing the reality of linkage between the burden of the minimum wage and its effects on small employers and workers, especially small business, similar to what was recognized a little less than a decade ago, the last time this issue was brought up.

Republican members insisted on the importance of small business tax relief several times over the last few years that small business was talked about. I have expressed that concern to Chairman Baucus and I thank him for recognizing the legitimacy of it. He also recognized the practical political reality.

That reality is, a minimum wage hike would likely not pass the Senate without a small business tax relief provision. So to those on his side who have been critical of Chairman Baucus for being practice, I would ask them how they would propose to get the minimum wage

increase across the goal line. It is one thing to live in a political or ideological fantasy land for members of both sides of the aisle, and it is quite another thing to make law.

This mark-up follows on the hearing we had just a week ago on this very same subject. At the hearing, we found that all of the major incentives before us today will tend to benefit businesses that will be burdened by the minimum wage increase.

Now, none of these provisions really has a partisan flavor, and that goes for the depreciation items and it also goes for the Work Opportunity Tax Credit. Despite that general nonpartisan flavor, members on my side of the aisle generally would prefer that the Chairman's mark tilt more towards current depreciation benefits and less towards work opportunity tax credit benefits.

I recognize and respect that sentiment and the policy basis behind it. However, Chairman Baucus has members on his side of the aisle that have different points of view that would prefer, for instance--and maybe it would deal with other things--but I will just mention the Work Opportunity Tax Credit.

Many in the Democratic caucus, I am led to believe from both newspaper accounts and comments, do not want any tax relief measure in this bill whatsoever. So I

think it is time for us to pull together, and so I take this opportunity to thank Chairman Baucus for not only working with me, but he made the point of consulting all members on both sides of the aisle on this issue.

He moved the mark-up away from the position of people that did not want any tax provisions whatsoever and much closer to the middle. Chairman Baucus struck a balance between the sentiments of Republicans and Democrats.

So I am pleased, Mr. Chairman, that the Finance Committee is again looking to do something in a bipartisan way, and kind of down the middle, the middle of the road.

Tax incentives targeted to small business and other businesses impacted by the minimum wage increase have been linked to minimum wage legislation by Republicans over a decade. Democrats, at times, have joined Republicans in supporting this linkage and we are going to find bipartisan support, I am sure, this time as well.

Last week at the hearing I quoted two former chairmen of the committee in their opening remarks on the conference agreement on the last piece of legislation that raised the minimum wage and also had connected with it the small business provisions.

Senator Roth, then chairman of the committee, described taxes as "the sand that grinds the gears o

small business". So, he saw merit in small business tax relief.

Senator Roth went on to say, "We will proceed to the legislation on the minimum wage and small business taxes. We are anxious to move ahead on small business tax legislation. Senator Moynihan, who then I believe was the Ranking Member, said, "My distinguished chairman, as always, has so stated the facts. But there is a small semantic issue here." He went on to say, "Some call this the small business tax relief. Others on this side," meaning the Democrats' side at that time, "call it the minimum wage bill. But we will not resolve that tonight, nor need we."

The bottom line then, is the Chairman's mark now before us contains a well-known set of small business tax relief measures. I look forward to helping the Chairman move this proposal along in committee and on the floor.

If I could, on another matter, a personnel matter, if I could have a point of personal privilege.

Chairman Baucus. Sure.

Senator Grassley. Friday will be the last day of a person who has been associated with this committee for the last seven or eight years, at least, in a leadership position, and has been associated with me in other committees or on my personal staff.

Ted Totman, who is the Deputy Chief of Staff for what was the Majority, and now the Minority, is leaving on Friday after 23 years of association with me, and a little longer association with Congress as a whole. I am going to miss him.

I do compliment him for, when he was going to leave in January of 2001 and I asked him if he could stay for a short period of time to help me move along with what then was a short period of time as chairman, but a longer period of time later on, and he did it.

So when he came to me in December and said he wanted to retire, I felt I could not beg him to stay any longer, and complimented him. He is beyond retirement age. He does not look it. But I want to thank him for serving me, for serving the people of Iowa.

He is not an Iowan, but you do not know the compliments I get from people in the health care industry in Iowa about how helpful Ted has been. He has been helpful to this committee and he has always been a sort of intermediary to make sure that this bipartisan relationship that Senator Baucus and I have to make this committee work, and to make the Senate work, and to produce product happened by working very closely with Senator Baucus' staff.

So I am going to miss him, but I wish him well.

Chairman Baucus. Well, Senator, I am going to tell you, we are going to miss him an awful lot, too, almost as much as you. I learned something this morning, and that is that Ted is not from Iowa. [Laughter].

He just seems like he is from Iowa. He is so much like you, being so gracious, so honest, so trustworthy, and just so helpful. I cannot think of a more decent man than Ted Totman. He is aces. I want to tell you, Ted, how much we are going to miss you, too. You are a good man.

[Applause]

Chairman Baucus. The first order of business before the committee is to organize for the 110th Congress, and to organize we must do a couple of things: one, adopt the committee rules; and second, make appointments to various committees on which the Finance Committee chooses members.

A quorum is present. I think you all have a copy of the rules before you. The rules to be proposed are exactly the same as they were in the last Congress. If there is no debate, I will ask for a motion.

Senator Grassley. I would move that issue.

Senator Stabenow. Second.

Chairman Baucus. A second was made. All those in favor, say aye.

[Chorus of ayes]

Chairman Baucus. Those opposed, no.

[No response]

Chairman Baucus. The ayes have it. The rules are adopted.

Also, this committee, pursuant to Section 8002A of the Internal Revenue Code, chooses five members of the Joint Committee on Taxation. Pursuant to Section 2107 of the Trade Act of 2002, the committee chooses five members of the Congressional Oversight Group. Pursuant to Section 161 of the Trade Act of 1974, the committee chooses five members to be the Congressional Advisors for Trade Policy and Negotiations.

In each case the statute calls for three members of the Majority and two for the Minority. It has been the practice of this committee to choose, for each of these groups, the most senior members on each side.

So is there any motion to make those appointments?

Senator Grassley. I so move.

Chairman Baucus. If there is no objection, then the motion is adopted.

[No response]

Chairman Baucus. That concludes the organizational matters before the committee at this point.

Small businesses create jobs, they create

opportunity, and they create innovation. Today, the committee can help small business and at the same time we can pass a tax package that can help enact a long-overdue increase in the minimum wage.

In my own State of Montana, we find small businesses. We are a small business State. Small businesses create jobs and spur the economy, as they do in Montana and other rural States. Today, we can help those small businesses.

We can help people like the owners of Dave's Soda & Pet City. Last week, Dave told us how Section 179 expensing helped him to afford lighting and electrical equipment for his stores and how it helped him compete with all the retail chain stores in the malls. It is very important to him as an independent business, because those stores in the malls have such advantages compared with other independent small businesses.

Today, we can extend Section 179 expensing for another year. That would allow small businesses to deduct up to $112,000 in equipment expenses. We can help small business with 15-year straight-line depreciation. Businesses put more money into their operations if they know that they can recover their improvement costs over 15 years, instead of 39.

Today, we can extend 15-year depreciation for those

folks and we can broaden the provision to allow retail owners and new restaurants to take advantage of this shortened depreciation period.

These are changes that Senators Conrad, Kerry, Snowe, and Kyl have championed. And they are right. We can help small business like those that a tax practitioner from Cleveland told us about, how the cash method of accounting can reduce small business bookkeeping burdens. We do that today and make it available to businesses with gross receipts up to $10 million instead of $5 million, and that will help those companies to a significant degree.

We can help small business like the franchise restaurant owner we met with last week. He told us how he used the Work Opportunity Tax Credit to employ workers who have encountered barriers to entering the workforce. I think, therefore, we should make that permanent.

We made an adjustment here in the mark so that it is not permanent, but would extend that five years. I think that will help. This is an issue championed by Senators Salazar and Snowe. And they are right.

I think we should make it permanent, as I said. But last week we met on the committee and the members had problems with that, and based on those problems I have reduced that permanent extension down to five years.

We can help small businesses by modifying S corporation rules. We can do that today. These are changes that Senators Lincoln and Hatch have championed, and I think they are right.

We have talked with many CPAs and small businesses. These are all provisions that will help small businesses. Senator Grassley and I have worked to develop, I believe, a very balanced package and I wish that we could have made some of these provisions permanent. But in a balance package of $8 billion, we have to trim some items back.

We have also paid for that $8 billion. The offsets are revenue raisers that this committee has supported several times before. The offsets include a proposal to end future tax benefits for abusive sale-in/lease-out tax shelters otherwise known as SILOs.

The offsets include doubling fines and penalties on tax underpayments related to certain abusive offshore financial arrangements. These offsets include closing corporate loopholes for companies who reinvented themselves as foreign corporations to avoid paying tax here in America.

I believe these are sound policy changes. I would want to move this package with or without a minimum wage increase, but by acting today we can help create a

sounder minimum wage bill. We can help to create a minimum wage bill that can get more than 60 votes and pass the Senate. We can help to create a minimum wage bill that the President will sign into law.

Our best chance to accomplish that goal is to keep this package trim, keep it compact. I, therefore, urge my colleagues to keep their amendments to a minimum. There will be other opportunities for those amendments. This is only January.

The committee will mark up education bills, it will mark up energy bills, it will mark up health measures, all this year. The House has already passed a minimum wage increase. The legislation is moving relatively quickly. So I urge those who might offer controversial amendments to defer those debates until later this year.

Today, let us help small businesses. Let us create a package that will help enact an increase in the minimum wage. Let us do the work that Americans sent us here to do.

Senator Lott. Mr. Chairman, can I ask an organizational question?

Chairman Baucus. Certainly.

Senator Lott. I would not want to get in front of our distinguished Ranking Member to comment on the legislation. But no mention was made in the organization

about subcommittees. I assume we are going to have subcommittees. Maybe you just have not had a time to complete that list. So I was wondering what the plan was with that.

Also, do we plan for our subcommittees to be active this year? In the past, traditionally, our subcommittees have been sort of passive, shall we say. Are we going to proceed pretty much the way we have in the past? Not that I am being critical, just an observation.

Chairman Baucus. Yes. Well, to your first point, there are still some wrinkles. Some members want to be on some subcommittees, and others, and that has not yet been worked out. We are working on that. I think it is more of an issue on your side of the aisle. Frankly, we are waiting until that is all cleared up on both sides before we can reach that point.

Second, I will keep the same practice with the subcommittees that we have had in the past. The activity of a subcommittee somewhat depends on the Ranking Member and the chairman of the subcommittee. If they want to be active, they can be active.

Senator Lott. Thank you.

Chairman Baucus. Do you have any remarks, Senator?

Senator Grassley. I gave mine already.

Chairman Baucus. All right.

We will now go to the mark. The mark is before us. The committee now has before it the Chairman's mark, and also a modification to that mark. The modification will be deemed incorporated into the Chairman's mark, so we have before us the Chairman's mark, as modified.

The Senator from Oregon?

Senator Wyden. Thank you, Mr. Chairman. Mr. Chairman, I would like to ask our witness--I think it is Mr. Barthold from the Joint Tax Committee--

Chairman Baucus. I think I asked Mr. Barthold to just very briefly run through the mark.

Senator Wyden. Very good.

Chairman Baucus. Then also, Mr. Barthold, if you might, very briefly, explain the offsets. Not all of them, but the ones that are more important.

Mr. Barthold. Thank you, Mr. Chairman. You have before you the description of the Chairman's mark since last Friday, and then the modification which was provided today.

I wanted to highlight, very briefly, two items in the Chairman's mark that the Chairman's staff has indicated were not clear and should be clarified for the committee.

It might be most useful for the members if we actually followed the revenue table that has been provided, the document labeled JCX-6-07.

Chairman Baucus. Do all members have that before them? Let us make sure we all have it so we are all working off the same page. Is this the one, Mr. Barthold?

Mr. Barthold. Yes.

Chairman Baucus. All right. JCX-6-07.

Mr. Barthold. Correct.

Chairman Baucus. All right.

Mr. Barthold. Item A-1-2, the extension of the 15-year recovery period for qualified leasehold and restaurant improvements, the mark description actually does not make it clear that the current law provision is being extended for leasehold improvements. In fact, that is the intent of the Chairman's mark.

Also, there is a discrepancy in the wording under one of the Subchapter S provisions that the Chairman had previously mentioned, and that relates to the sale of interest in qualifying S corporation subsidiaries. The document, says "dispositions." The narrower term of sale is what is--

Chairman Baucus. Well, I do not see that here.

Mr. Barthold. I am sorry, Mr. Chairman. That is item A-2-4, "Treatment of Sale of Interest in a Qualified Subchapter S."

Chairman Baucus. All right. Thank you.

Mr. Barthold. The description on the table is, in this case, superior to the description in the document.

Chairman Baucus. All right.

Mr. Barthold. Now, as the Chairman had indicated, the Chairman's modification provides the offsets for the provisions of the Chairman's mark. The committee has in the past actually passed all of these offsets, with two exceptions. So I will just briefly list the ones that have been passed by the committee in the past and then briefly describe the two new offsets.

Provision V-1, under "Revenue Provisions", so the first item at the bottom of the first page of the revenue table, as the Chairman noted, modifies the effective date for the application of the lost limitation rules to SILO transactions.

At the top of page 2, there is a modification to the effective date of the treatment of inverted corporations as domestic corporations. Items 3 and 4 relate to denying deductions for punitive damages and for certain fines and penalties.

Item 5 would modify the present law tax regime that applies to individuals who expatriate to move to a mark-to-market regime. All of those provisions have previously passed the committee.

Item 6 is a new provision in the Chairman's mark, or

new to the committee. What this provision does, is this places a new limit on the annual amount of non-qualified deferred compensation, providing that the amount that may be deferred annually by an individual under a non-qualified plan may not exceed the lesser of $1 million, or the individual's annualized includable compensation.

Now, turning back to the table--

Senator Bunning. Mr. Chairman, may we ask questions or shall we wait till he is finished?

Chairman Baucus. Let him go all the way through and then come back. Let us get a sense of what this is all about, then you will be the first one I will recognize, after Senator Wyden.

Senator Smith. Could I be the second?

Chairman Baucus. Well, to modify it, now you will be the third. You will get in there. There will be plenty of opportunity.

All right. Go ahead.

Mr. Barthold. Items 7, 8 and 9 all increase penalties that exist under present law, and the committee has previously adopted these provisions.

Item 10 changes the amount of interest that can be deductible for certain contingent convertible debt instruments. Item 11 extends IRS user fees. Items 12 and 13 modify due process procedures and IRS whistle-

blower procedures.

Item 14 is another provision that is new before the committee, and this modifies the definition of "covered employee" under the Code Section 162M limitation on the amount of deductible compensation of highly paid employees.

Basically, it says that once an employee is identified as a covered employee, that individual remains a covered employee in subsequent years. It also eliminates what some deem to be a defect in the provision, that if one was not a covered employee at the end of the year but had been a covered employee at another point during the year, then the provision continues to apply. That finishes my brief summary and I would be happy to answer any questions.

Chairman Baucus. Thank you very much, Tom.

Senator Wyden?

Senator Wyden. Thank you, Mr. Chairman. Mr. Chairman, first, let me commend you. You have had an extraordinarily difficult exercise to make your way through, and as usual you have worked on it in a bipartisan way and I want to commend you for your efforts.

Now, my question for you to start with, Mr. Barthold, is by my count there are at least 40 changes in tax law

under this particular proposal. As far as I can tell, there are 13 small business provisions and 27 offsets. I tried to do that in the broadest kind of way. Can you confirm that, or modify my assessment of it?

Mr. Barthold. Senator, I had not looked at things, I guess, the way you had. When we had prepared the material for the committee we tabulated them out by the line items as they appear on the table. So, I have 13 items under the tax relief Title A, and 14 under the revenue raising provisions. A total of 27, 13 on the tax relief side, 14 on the revenue increase side.

Senator Wyden. And obviously within some of those categories there are additional changes as well. Is that not correct?

Mr. Barthold. Well, if you are talking about when the staffs work with the legislation counsel in terms of how many lines of the Internal Revenue Code have to be modified, of course, certainly there are there multiple changes within individual Code sections.

Senator Wyden. Mr. Chairman and colleagues, I bring this up only by way of saying that there have been 14,000 changes made in the Tax Code since the last time we took on tax reform. It comes to something like three for every working day in the last two decades.

It just seems to me, as difficult as this exercise

is, we are going to have to be very careful about making the Tax Code more complicated every time we come together, because when I go home, what I hear from small businesses and everybody else is, they want to see us eliminate preferences, broaden the base, and hold the rates down for everybody.

So it is my intention, Mr. Chairman, to support you today. You have had a very difficult job of trying to move this forward, and I particularly appreciate your support for raising the minimum wage.

But I just want to make it clear that I am very concerned about constantly adding more and more provisions to the Code that take away from the opportunity to broaden the base and lower the rates. I look forward to having those discussions.

Chairman Baucus. Thank you, Senator.

Senator Bunning is next.

Senator Lott. And I would like to get just a general comment after that.

Senator Bunning. Thank you, Mr. Chairman.

Mr. Barthold, would you help me to understand "non-qualified deferred compensation" that are included in the modified mark? It seems to be a little draconian to me. So I would like a further explanation, if there is one, than you gave.

Mr. Barthold. Thank you, Senator. I will try and elaborate a little bit.

Under present law, there is qualified deferred compensation, such as pension plans, for which there is an exclusion, and then there are non-qualified deferred compensation. There are certain rules under present law that relate to non-qualified deferred compensation plans that go to things such as timing, but has not related to amounts.

What this proposal does, is it imposes an additional requirement on the underlying rules and those requirements are to set an annual aggregate amount that can be deferred under a non-qualified plan.

Senator Bunning. Yes. Presently being at $1 million?

Mr. Barthold. The proposal is not to exceed the lesser of $1 million, or the individual's annualized includable.

Senator Bunning. And may I ask a follow-up question about tax treatment of the additional deferred compensation. Is that corporate responsibility or is that individual responsibility?

Mr. Barthold. It is included in the individual's income, Senator.

Senator Bunning. In other words, in the year it is

deferred?

Mr. Barthold. Yes.

Senator Bunning. So if someone is qualified for $1 million deferred and you add another $1 million, that is deductible from the corporate structure and it is the responsibility of the individual to pay money that year on the additional $1 million?

Mr. Barthold. The basic tax rule still applies, that if there is an inclusion to the individual there is a deduction to the taxpayer paying the individual.

Senator Bunning. To a corporation.

Mr. Barthold. A corporation.

Senator Bunning. So they get that deduction.

Mr. Barthold. Yes.

Senator Bunning. But the individual receiving it must pay in the year it is deferred?

Mr. Barthold. If it is an includable.

Senator Bunning. If it is over $1 million.

Mr. Barthold. Yes.

Senator Bunning. All right. That is much clearer. Thank you.

Senator Smith. Mr. Chairman?

Chairman Baucus. Senator Smith was next. If he wants to defer, that is fine, but he was next in line.

Senator Smith. I will defer to Senator Lott and I

will go after him.

Senator Lott. Is it on this point?

Senator Smith. No.

Senator Lott. Let me make just a brief statement, Mr. Chairman, if I could, and I thank Senator Smith for allowing me to do that.

First of all, I am glad we are having this session. There are those that did not want to have small business benefits as part of the package and just wanted to go with the increase in minimum wage.

I was involved back the last time we did this, and we got a minimum wage increase, we included some small business benefits, and it worked well. You did not have entry-level, beginner workers lose their jobs.

The incentives, benefits and relief in terms of regulatory reform definitely helped small businesses. I agree with you. I think we should be doing this whether it is connected with minimum wage or not.

So I think that you have moved from what could have been a real difficult thing to come up with a reasonable package, in many respects, that will help us get this through the Senate and eventually get a result.

I certainly did not want to make it a permanent Work Opportunity Tax Credit without other tax provisions being made permanent. You have moved back from that. I still

feel like too much of what we are doing here is in that one area, about half the money involved.

I would like to have done more on the expensing and depreciation side. We will have an opportunity to offer amendments on that, either here or on the floor of the Senate, and some of us, I am sure, would do that.

But I do think you have come a long way. As usual, you and Senator Grassley are making it difficult for members on both sides to oppose what you have come up with here.

I do think it is very important that we, this year, also address the biggest issue of a lot of small business men and women, and that is the ability to provide health care coverage for their workers. I am very much for the small business health plans, or some way.

I have talked to a lot of small business men and women that would like to provide coverage, but small businesses work on an infinitesimal profit margin. If they have 55 workers, they might could provide health care for 5 of them, but not the other 50.

I really think it ought to be attached to this. When you talk entry-level workers, most of them are not making minimum wage now. You cannot hire somebody to work in a restaurant, now, or a pizza store for the minimum wage. You have to pay more. What they are missing, is health

care opportunities.

I think we should attach it to this legislation. Perhaps that will come on the floor of the Senate, or maybe later on in the year. But I hope this committee will make sure we addressed that, because for the small business men and women and their workers, there is nothing more critical right now than having a way to get health care coverage.

So I would like to increase what we provide to small businesses in tax relief, but I think you have moved a long way in the right direction and I think you should get some credit for that.

I know you have probably got some on your side that do not like it, but we are going to be able to get it through the committee. We will get it to the floor, next week, I presume, and hopefully we can continue to work to make it workable and helpful to small business men and women, and the workers.

Thank you.

Chairman Baucus. Thank you, Senator. In fact, I agree. There were over 30 amendments, filed by members of this committee related to health care, to this bill. There were not a lot of amendments filed to this bill, so health care was the bulk of those filed.

I very much agree with you. Health insurance is

going to be a major focus of this committee, and soon. When I am home, I hear what you just said, for all the reasons that you mentioned. It is just that this is not the time and place on this bill, I think, to think through those health insurance provisions.

In fact, we will be having hearings on health care and health care costs, what we can do to reduce health care costs for Americans. It is my hope that those hearings will be soon.

There are other conversations and negotiations going on, and we can come up with a thoughtful package that addresses small business health needs. Senator Enzi on the Health Committee, Senator Kennedy, and many of us have been working to try to address health care for small business. This committee can certainly play a very large role in that regard, and it is my intention to do so. But you make a very good point.

Senator Smith?

Senator Smith. Senator Baucus, Mr. Chairman, thank you for your hard work on this bill. I note that you have included a number of the S corporation reforms that I helped to author, and they will, I know, help small businesses in all of our States.

I look forward to working with you between now and the floor to make sure that these reforms take place more

quickly. By that, what I mean is being able to harmonize the effect dates for S corporations. That is going to be important in order for this to be fully effective.

Mr. Chairman, I had intended to offer an amendment. I understand it would be ruled non-germane. To the point that Senator Lott was making and you were agreeing to, one of the greatest issues facing small business is affordability of health care.

As a background, let me just say that, under current law, self-employed individuals, including sole proprietorships and small business people, are allowed to deduct health insurance premiums for themselves, spouses, and their dependents. However, they are not permitted to deduct the cost of coverage of their domestic partners.

I know that some people are troubled that we would extend this deduction to non-traditional families. I was intending to offer this with Senator Schumer. We will wait until the floor, or perhaps you can give us some time certain where we will take up health care for small business and include this.

I will work with you, Mr. Chairman. But my motive in this is, I like to cut taxes. I particularly like to cut them for small business, and I like to make health care more affordable, and this would do so.

It has no requirement that small businesses provide

health insurance, but if they do, I think we ought to cover more people. Whether we like it or not, there are non-traditional families out there and I would like them to have benefits as well.

I have skinnied it down to one year, simply to lower the cost to see what the effect would be, but out of respect for this committee and my Chairman, I will not offer that now. But thank you.

Chairman Baucus. Senator, I think your proposal has a lot of merit and we will consider it later this year, as early as we possibly can.

Senator Kyl?

Senator Kyl. Thank you, Mr. Chairman. I will add my voice to those who also believe we need to be adding small business health plans or some kind of insurance support for the small business employees, in particular, and respect your desire that we not deal with that this morning.

I have a question that I would like to ask staff, and then make a comment based upon that, whoever can answer this question.

In terms of the cost of this program in total, if you add up all of the elements of it, it is in the neighborhood of about $8 billion, as I recall. I am wondering if you have calculated, or if you can

determine, the distribution of the tax benefits in a notional way between small businesses and big businesses.

In other words, clearly these expensing provisions are going to be of great benefit to the small businesses, like Dave, our restaurant witness that you mentioned, Mr. Chairman, whereas, the Work Opportunity Tax Credit, because of the requirement for a lot of work to set those up, will benefit the larger businesses more significantly.

In terms of the amount of money going to the small businesses versus the larger businesses as a result of the tax relief that we provide here, how would you characterize that distribution? You can comment on that.

Mr. Barthold. Senator, as you know from past discussions, it is difficult to define "small" versus "large". There is not one well-defined cut-off.

Just to qualitatively characterize some of the provisions, as you noted, the 179 expensing provision is really geared at businesses that make small amounts of capital expenditures per year. Now, while that includes probably most small businesses, there are also always some large businesses which do not make large amounts of capital expenditures per year.

Likewise, the leasehold improvement, the restaurant provisions, the retail improvements, those can apply to a

large business in the business of commercial real estate, but the hope is that this makes costs lower for people operating the restaurants, the retail establishments, which again, there are many small businesses there, although there are sometimes also large businesses.

The cash accounting method, of course, is really looking to define "small" in terms of sort of current gross receipts, and so that stands as it is. You had asked your staff to ask us yesterday if there was any information that we might be able to get on the distribution of the Work Opportunity Tax Credit, and the staff did do some work overnight.

It is a little bit, as it is in many things that we look at, of a mixed bag. I will try and characterize some of this work. Let me note that the work is incomplete because the Work Opportunity Tax Credit can be claimed both by businesses that are organized as corporations and then businesses that are sole proprietorships or pass-through entities.

So when we tried to look at this work, it comes to us in our data from multiple sources, the corporate returns and then the individual returns. Again, it is not possible on some of those returns to characterize a business as "small" or "large".

The Work Opportunity Tax Credit, for example, could

be passed through from a partnership to passive investors, but it might be a passive investor in what, if you knew the business, you might characterize as a large business.

Now, all those caveats said, about 95 percent for tax year 2004, and we also looked at 2003--roughly the same in terms of percentages. About 95 percent of the total Work Opportunity Tax Credits claimed were claimed by C or S corporations, so 5 percent went to sole proprietorships or other pass-throughs.

But in fact the number of taxpayers who claimed the credit, the ratio was about 3:1 in terms of sole proprietors, partnerships, other pass-throughs as opposed to S corporations and C corporations.

So in one look at things, businesses organized as corporations, particularly C corporations, claimed most of the dollars of the credits, but in terms of number of claimants, there were substantially a large number of credit claimants who were not organized that way, and so you might characterize it as potentially quite small businesses.

Senator Kyl. First of all, I thank you for that work and I think it is useful for us to continue to try to define this, because I think it makes a point I would like to make here. That is that, while you have an awful

lot of people in small businesses that may file for the claim, the reality is that the vast majority of the money that benefits business here is for the larger businesses. And I recognize all the caveats that you noted there.

But if our effort here is to help small businesses, like our restauranteur, Dave, it seems to me that we should be focusing mostly on those tax areas that provide the bulk of the benefit to the smaller businesses and that the package, as much as the chairman has tried to create a politically supportable package here, in my own view it is skewed too much in the way of providing the tax benefits for the larger businesses and not enough for the smaller businesses, given the finite amount of money that we are talking about here.

Now, I am all for all of these benefits. I would like to make all of these provisions permanent, so just to be on the record, I am for codifying all of this in a permanent way.

But if we are stuck with, in effect, $8 or $9 billion of revenue that we can afford to give up here because of the offsets that we have identified and we are, therefore, dividing that $8-plus billion of tax benefits, it seems to me that we can do a better job than providing a five-year extension of the Work Opportunity Tax Credit and only a three-month extension of a couple of the other

provisions, or in another case, a year. In the case of the new provision, by the time we actually enact this it probably will be in effect less than a year.

So I will have an amendment a little bit later on that tries to deal with this imbalance or inequity here between what we are providing for small business versus the larger businesses, recognizing that I would like to do the maximum amount for all.

But the key thing that, as a committee, we need to, I think, be aware of here, is the whole reason we are talking about extending some of these tax benefits is because they promote new job creation. We know the studies that talk about job losses as a result of increasing the minimum wage, but we also know that we can ameliorate that by tax provisions that create new jobs.

Now, unlike the WOTC, some of these expensing provisions, depreciation provisions are noted for the fact that they can create new jobs. Just to cite a couple of statistics, CBO has estimated that the minimum wage increase that we are proposing here will impose about $4 billion in new costs on the private sector in 2009, $5.7 billion in 2010, and with the increased costs extending into the future of about $5 billion a year.

The studies also show, as I noted, that the job losses that result from increasing the minimum wage hit

the lower-skilled entry-level employees the hardest.

An employer who is confronting increased labor costs will naturally retain the most skilled and productive employees and will cut or reduce the work hours for the less skilled. That is just the way that it works. That is why we are looking at these tax provisions to see if we can overcome that negative effect of the minimum wage increase.

We heard testimony at last week's hearing that verified the actual empirical studies that I have noted here. One of the reasons we are focused on the restaurants, is apparently, according to the statistics, about 60 percent of the workers earning minimum wage work in the food service industry, and so that is one of the reasons we are focused.

Chairman Baucus. Senator, if you can be brief here. A lot of Senators want to be recognized, too.

Senator Kyl. Well, I would be happy to make the rest of my remarks when I introduce my amendments.

Chairman Baucus. Whatever you want to do. Just, in the interest of accommodating other members--

Senator Kyl. I would be happy to give somebody else an opportunity to comment right now.

Chairman Baucus. Well, the list I have, and tell me if others want to seek recognition, is: Senators

Stabenow, Lincoln, Kerry, Bingaman, Snowe, and Salazar.

Senator Stabenow?

Senator Stabenow. Thank you, Mr. Chairman. First, I want to thank you for putting together a balanced bill on what I know is very difficult with many interests. Mr. Chairman, I have shared with you, as many of the members have, about the interest in small business health care. I think that the general consensus is, we want to move in that direction.

So I want to thank you for making your commitment to move ahead to speak about small business health care at another time, because we know that it is three times more likely that a small business employee will be uninsured than someone working for a large firm. I know that we all are hearing from people at home, so I am anxious to do that at a later point.

I wanted to just mention that Senator Snowe and I are working on health information technology initiatives that would save hundreds of billions of dollars that we could redirect to funding other health initiatives. Senator Lott and I are working on issues related to generic drugs that will also save dollars. So, I know other members have important ideas and I am looking forward to that.

Mr. Chairman, I think it is important for us, when we look at this, to also recognize that most of these

provisions we have passed on a bipartisan basis in the past, which makes this a good place to start as we look at tax reform.

I want to particularly thank you, as it relates to the Work Opportunity Tax Credit, for the expansions. I think it is important to note that this would expand to disabled veterans and to young people who are disadvantaged, and to those who, frankly, many of whom are receiving work from small businesses. Part of this--an important part of this--is to create opportunities for jobs, for work for people. That is what the Work Opportunity Tax Credit does.

I did have one question, Mr. Chairman, for staff. An issue has been raised this morning to me regarding the professional employee organizations and the employee tax credits involved. I wondered if you might explain how that would affect an employee working for a business and how those tax credits are configured.

Mr. Barthold. Thank you, Senator. The Chairman's provision with respect to the professional employee organizations provides -- I guess the terminology would be, the client organization can claim a tax credit, such as the Work Opportunity Tax Credit, with respect to a worker on site who might otherwise under the provision be considered the employee of the professional employee

organization. Does that address the question?

Senator Stabenow. It does. Mr. Chairman, in the interest of time I would just like to work with you as this goes to the floor on that language. So, thank you.

Chairman Baucus. Thank you very much. Thank you, Senator.

Senator Lincoln?

Senator Lincoln. Thank you, Mr. Chairman. Again, thank you so much for bringing us so quickly into this arena of addressing issues for small business. Once again, you and Senator Grassley have come together, I think, in a very practical way to help us move forward some issues that will be tremendous tools for small business, and certainly tremendous tools in our economy.

I think that is so important for us to move forward. I think it is important for us to also recognize what you two have recognized, and that is that we cannot do everything at once.

This is a very, very good beginning. I think, because both sides want more in some areas and less in others, it clearly indicates that you all have worked very hard to bring about a good, moderate, as well as practical bill, something we can get done.

I think that is what people want to see us doing. They want to see us productive. They want to see us

bringing results. I think this is the kind of bill that will do that.

As you noticed, I filed three amendments which I felt like were issues that are important for this committee to take up, but filed them with the respect for what you all have done, that this is not the appropriate time, perhaps, to do these things.

I am very grateful for your expression of concern, as well as intentions in terms of addressing things like health care for small businesses, and some of the other initiatives that we can do.

Senator Snowe and I have been working, and I am so grateful for her leadership on the Small Business Committee and the things that she has already done. But we have been working together to look at what we can provide for small businesses in terms of the relief, as Senator Smith mentioned, the real need to be able to provide the them the tools that they need and the help that they need for something that is a huge issue for them, and that is providing health care to their employees.

So I am very grateful to Senator Snowe. She and her staff, as always, have been incredibly wonderful to work with. I think as we move forward and you and Senator Grassley begin to look at the opportunity where, in this

committee, we can move something forward, I am excited about playing a role in that and look forward, again, to continuing the work with Senator Snowe that we have begun on the small business aspect of that.

Also in terms of the expensing, the cash method accounting, the pieces that are in here that, again, as I said, I believe really get the ball rolling and move forward, are things that Senator Smith and I have worked on in our BOOST Act that we introduced in the last session of Congress.

Again, looking at the opportunity that we have right now to move some things forward, I think, is the best possible scenario we could have gotten out of this, Mr. Chairman.

I am just grateful for your leadership in being able to be practical and realistic about what we can move, and certainly grateful for your expression of intentions in taking up these other very important issues that all of us want to be engaged with.

I think the committee is anxious and ready to work with you and Senator Grassley to take those next steps as we move forward with this. Again, my amendments reflect some of the assistance I want to provide, again working with Senator Smith, for our small family-owned timber businesses who do a tremendous amount in terms of

stewardship of the land, as well as the ESOPs, which make a tremendous contribution in this country to the economy, as well as to workers. So I am grateful for what you have done. I am looking forward to being helpful in any possible way that I can.

But again, I am very grateful to you and Senator Grassley for setting the example of pointing out that it is results that count to our constituents, and that they want to see us productive and we sometimes have to take that step by step, and that is what we are doing here. So, thanks to both of you all for your leadership in that regard.

I look forward to continuing to work with you to solve many of these problems, and I think you have got a very willing and able committee here that, as we are all anxious to put everything on this bill, we will be just as anxious to work with you in the weeks to come to solve those problems. We look forward to it.

Chairman Baucus. Thank you very much, Senator. I might add, I am going to work as hard as I can to make these little sessions we have had work. By "sessions", I mean the one we had before we marked up this bill, where all members of the committee got together in the same room and talked over the bill so we have as much of a committee document as we can possibly have.

Or to say it differently, it is not my intention to, willy-nilly, summarily shut out some of the amendments that have been filed. The goal, rather, is to get them included as much as possible early on. I just say that so that members know when they come to those meetings, these are real meetings. These are meetings where we are going to do a lot of work.

Senator Bingaman?

Senator Bingaman. Thank you, Mr. Chairman. I filed two amendments. I congratulate you and Senator Grassley for your effort in putting this package together. I will not offer either one based on your desires here this morning, but I wanted to just flag them for you.

One relates to the Hope scholarship credit. Senator Smith and I have worked on this jointly. We would like to see that credit expanded so it does more good for the people that really need the assistance in going to college. I think there will be a chance, perhaps, to do that sort of at the same time as we are doing the reauthorization of higher education. I hope that we can do some tax provisions.

Chairman Baucus. I plan to. We will.

Senator Bingaman. The other, relates to health care. In calculating payroll tax liability, it is my understanding most businesses are allowed to deduct

whatever they extend for health care. That is not true for the self-employed, and it should be.

That is the other amendment. I would like very much to see the self-employed have the same benefit of being able to deduct their health care expenditures in calculation of their payroll tax that presently is possible for other businesses. So, that is the other amendment.

Again, I am advised that you are planning to have another opportunity later in the year when we could offer some of these health care-specific type of amendments, but this is one which I think would be of great benefit to self-employed individuals around the country and I hope we can seriously consider that, and hopefully adopt it.

Chairman Baucus. I thank you, Senator. In fact, it would be my hope that we would have a health care package soon, it is my hope that we have an education package soon, it is my hope that we have an energy package soon, and I will stop there for the moment. [Laughter].

Senator Grassley. But that will take us up to Labor Day.

Chairman Baucus. It will take us a while. That means, too, sequencing it and ordering it along with the rest of the Senate, and that is working with the

Committee on Health and Education, working with your committee, Senator, in energy so that we are working together as much as we possibly can.

Senator Roberts. And, Mr. Chairman, do not forget agriculture and the farm bill.

Chairman Baucus. Oh, agriculture. Right. It is interesting that you say that because, as you know, we are also considering to some degree some energy provisions, as well as some other tax provisions, on the farm bill. That is true. But thank you.

Senator Roberts. Thank you.

Chairman Baucus. And thanks for your efforts. We look forward to your contribution on the energy bill.

Senator Snowe?

Senator Snowe. Thank you, Mr. Chairman. I, too, want to join in the chorus of commendations to you for having this mark-up here today, your first mark-up as chair of this committee, that undertakes a significant tax relief program to benefit small business owners throughout America.

I also commend you and Ranking Member Grassley for working together in a bipartisan manner. Again, it is a hallmark of this committee, and I thank both of you for taking the lead in initiating a consensus-based package that ultimately can achieve victory early on in this

Congress.

Most significantly, by paving the way for these tax incentives for small business owners, it can be a legislative win-win, both for the workers and the American economy.

I unequivocally support an increase in minimum wage; long overdue. I think we have to explore policies that narrow the wage gap in America, and the disproportionate gap between high-income and low-income needs to be addressed. I do think that is another issue that clearly has, I think, a compelling interest for our Nation.

As far as small business is concerned, as the former chair of the committee, and now Senator Kerry is the chair of that committee and I am now Ranking, I have conducted a number of hearings on numerous questions.

I applaud you for the provisions that you have included in this legislation, ones that I have long championed and worked across the aisle on, that I think will help to bring significant relief to small businesses, which they certainly deserve because they face many obstacles.

One is obviously the burden of the Tax Code and compliance and the administrative and regulatory complexities that increases the cost by 67 percent more than costs comparable for larger firms.

The same is true for the regulatory burden. We have all heard about the health care crisis because that is what it is. It is a crisis among small business owners in America. I am delighted to work with Senator Lincoln on this very question. She is championing this initiative, and also Senator Stabenow on health information technology.

I have another amendment on cafeteria plans that I hope I can offer in the future, but I think the bottom line is, we need to generate significant bipartisan support, I think, to secure passage of a provision that will provide relief to small business owners, because currently, as we all well know, they basically are able to pay for catastrophic coverage, with policies ranging from $5 to $15,000 deductibles. So it is imperative that we address this issue, explore it, and to move in a timely fashion to get it done.

I have offered initiatives on this in the past. I have had repeated hearings on this question. Small business owners are pleading, and certainly in my State but across the country, that we need to address this very legitimate issue, especially in small group markets where there are very few insurers.

My State is a good example of that, where we have few insurers that consolidated their market share and,

therefore, there is no leveraging with respect to purchasing power.

That is why it requires action on the part of the Congress, to be able to transcend the rules that exist today, to enable small business owners to have the same purchasing power as large corporations and unions do. That does not exist, and therefore they are bearing the inordinate burden.

And, frankly, a disproportionate number of uninsured in America are those who are small business owners or those who work for them, or families who depend on workers who are in small businesses, the disproportionate number of the uninsured in America with employees with 25 or fewer, or 10 or fewer.

We have seen the number decline in terms of small business owners who are able to provide this significant benefit to their employees, so therefore they are less competitive with other employers who are able to provide it because they are a larger company.

So, the bottom line is here, we need to ge this done. But I want to congratulate you for what you have done here today, because I think it does pave the way for securing victory on these much-needed and critical pieces of tax relief for small businesses who, by the way, are the net generator of jobs in America.

They create 75 percent of all the net new jobs. They are 99 percent of all our employers. They represent 51 percent of the private sector output and 51 percent of the workforce.

So, I think we should explore ways in which we can ensure the long-term vitality of this economy by benefitting small businesses, because if we do that we will create more jobs in America.

Thank you.

Chairman Baucus. Thank you, Senator. Well said.

Senator Salazar?

Senator Salazar. Thank you very much, Mr. Chairman. I join my colleagues in accolades to both you and Senator Grassley for the example that you set and for the Chairman's mark, and I look forward to making it a reality with you as we move forward to the floor.

Five quick points. First, on the minimum wage, I think it is exactly the right thing that we ought to be doing because it is the right thing to do, and second, because otherwise we are going to see a patchwork of minimum wage initiatives all over the country.

We certainly saw that in Colorado this last year where we had a minimum wage initiative that was essentially put on the ballot by the voters. So, I think it is the right thing for us to do because it is

something that is going to happen in the States unless we give it attention here.

Second, on the small business incentives that we have here, I echo the comments that everybody has made here. Many of us have experience in small business. My wife ran a Dairy Queen for a number of years, until a couple of years ago.

When you are hiring 20 people and you are going through the 39-year depreciation allowances, these kinds of tax incentives that are in here for a small business are going to be very helpful. And I agree with Senator Snowe's comment very much. At the end of the day, 75 percent of the workforce essentially comes from small business.

The third point, on the Work Opportunity Tax Credit. Mr. Chairman, I appreciate the extension of the Work Opportunity Tax Credits to disabled veterans coming back from the Iraq and Afghanistan conflict. No matter where people are on the conflict and the war, I think Americans are 100 percent supportive of our veterans, and providing opportunities for our veterans to take advantage of these employment opportunities through WOTC is something that I very much support.

The fourth, and maybe my last point, is that the comments that have been made here on health care, I

think, are very important. I remember working with Senator Enzi, Senator Kennedy, Senator Lincoln, Senator Durbin, and others as we tried to address that issue. So how we deal with small business and health care is, I think, one of the most important agenda items that we have.

Thank you, Mr. Chairman.

Chairman Baucus. Thank you very much, Senator.

Next on my list, and final on my list, is Senator Schumer.

Senator Schumer. Thank you, Mr. Chairman. I want to thank you and Senator Grassley for putting together a balanced package here, balanced in the sense of creating a bipartisan majority.

Substantively, it is not balanced, in my judgment. If I had my druthers, we would just pass the minimum wage without any more tax breaks for small business. After all, we have done a lot of those over the last six years and we have done noting on minimum wage.

To sort of put them on equality would not be my value choice, but we live in a bipartisan world here. We have to get things done in a bipartisan way, and that is what compromise is all about.

But again, if I had my druthers we would just do straight minimum wage and deal with small business taxes

in a larger context, talking about deductions for health care, which I would put at the top of the list, and other things.

Having said that, I think the tax package in here is balanced. I would just like to make the point, I know some of my colleagues talked against WOTC. That is the one tax cut in here that has something to do with minimum wage.

That is the one tax cut in here that encourages employers to hire new people, some of them, albeit, at a slightly higher salary. And, like any other tax break that is across the board, some of it goes to big business, but the vast majority goes to small business because small business employs the most people here in America anyway.

The other tax cuts--which are tax cuts that I would generally support if we did not have a huge budget deficit and we had plenty of money--are good, but they are not related to hiring people.

They can get those tax cuts and not hire a single new person in some of them, and in others there is not much bang for the buck. Forty-four percent of this package is WOTC. I would remind my colleagues on the other side of the aisle, we are 50, 51, and so we are giving in a little more, maybe, plus the fact that there is a tax

package altogether.

But again, the tantamount desire is not for each person to get his or her way, but to come up with an agreement where we can get something done. So, I will be happy to support this package, and I thank Senator Grassley for joining our leader, Senator Baucus, in putting this together.

Chairman Baucus. Thank you, Senator.

Are there any amendments?

Senator Kyl. Mr. Chairman, the amendment that I have is number 23, I believe. It is called Kyl Amendment Number 1. Let me begin by saying, the only comments I heard about WOTC, I did not hear anybody talking about WOTC earlier, to respond to Senator Schumer, but I did note that I felt there was an imbalance in this tax package if the WOTC relief is extended for five years, and most of the relief that mostly helps small businesses extended for three months.

And, second, as staff indicated--and I do not believe you were here, Senator Schumer--the vast majority of the tax relief, in dollar terms, does go to the larger businesses, not to the smaller businesses under WOTC.

The problem is that WOTC does not create jobs. What it does do, is to provide relief to employers that hire people, and ordinarily people that they were going to be

hiring in any event.

There was a study, for example, performed by the Department of Labor that concluded, among other things, that tax credits played little or no role in the recruitment policies, suggesting that they would have hired members in the target groups even if the program were not available.

I support it nonetheless, but I think we have to acknowledge that the only provisions in the market actually relate to job creation, new jobs for small businesses, or these other expensing depreciation provisions. Ordinarily we extend these tax provisions for the same length of time, but in this proposed mark we are not doing that.

Yet in the testimony before the committee, which we are supposed to pay some attention to, when the witnesses were asked to rank the relief that would be most beneficial to them among depreciation expensing and WOTC, WOTC was the least beneficial to those businesses, according to the three witnesses.

Let me just add one final point. Senator Snowe certainly made the point, and then others certainly agreed with her, and I agree with her, about the importance of small business, the job creation of small business and the importance of these expensing and

depreciation provisions to small business.

But we should not be patting ourselves on the back so much for the great relief that we are going to provide if all we are doing is extending these provisions for three months to go to the end of the first quarter of next year.

In other words, these are not provisions that are already extended way out into the future. The only exception is the Section 179 expensing and that goes, under this mark, to 2010. All of these others are only extended to the end of the first quarter of next year, whereas, the WOTC extension is for five years, through 2012. Now, that is not a balanced program, number one.

Second, it does not go to the heart of helping the small businesses because the bulk of the relief, as we said, under WOTC, goes to the larger businesses. So before we pat ourselves on the back for doing a great job for small business, I would like to suggest that we try to balance this package a little bit more to help the small businesses that we all are rightfully claiming to care so much about. When you get into the details of the package, it is not as balanced as it should be.

So my proposal is to compromise by simply bringing them all to the same date as the Section 179 expensing, which is the year 2010. We can do that. We can extend

the expensing and depreciation deductions to that point. WOTC would go from 2012 to 2010, but all of the others would move forward to 2010.

It seems to me that while that would extend or increase the cost of the package to some extent, that, A, we do not necessarily have to pay for that additional increment, or if we do, we can find a way to do that.

But, Mr. Chairman, I think we need to go on record here as supporting a more balanced package that actually benefits small business than one which simply extends through the end of the first quarter of next year the benefits that we have all talked so much about.

Chairman Baucus. The question I have--I appreciate that, Senator--is your amendment, as I understand it, is to extend the leasehold improvement to what year?

Senator Kyl. 2010.

Chairman Baucus. Do you do the same with Section 179?

Senator Kyl. Section 179 is already extended to 2010 under your mark.

Chairman Baucus. Yes. Do you have an estimate as to how much your amendment will cost?

Senator Kyl. There is no official estimate, obviously, because of the time constraint.

Chairman Baucus. Do you have an offset?

Senator Kyl. Well, we do not know what the amount is. Since we are bringing the WOTC back from 2012 to 2010, there is a savings associated with that and then there is an expense associated with bringing these others forward to 2010.

Chairman Baucus. Yes.

Senator Kyl. Section 179 is a wash because that is already extended to 2010. So, no, I do not have a number.

Chairman Baucus. Let me ask the Joint Committee. Does the Joint Committee have an estimate as to what the amendment of the Senator from Arizona might cost? Not the WOTC backing down a couple of years, but just what the amendment itself would cost, just a best estimate.

Mr. Barthold. I am sorry, Mr. Chairman and Senator. We have not had an opportunity to estimate extending the provisions for leasehold improvements, new restaurant and retail, out through 2010. We have not had an opportunity.

Chairman Baucus. This is a rough estimate, but our estimate is that it would cost about $5.2 billion, and bringing WOTC back would not come close to covering that, even though that, in my judgment, would not be the right policy anyway.

Senator Kyl. Mr. Chairman, I appreciate that.

While I am not going to comment on your estimate, I think you are correct that bringing WOTC back two years would not necessarily pay for this amount.

But I do think it is important for this committee to go on record, since we all agree we want to try to help small businesses to the maximum extent, and I think we would all agree that just extending these other important provisions by three months, we cannot in good conscience claim that we have done everything we can do to help small businesses.

I think it is important for the committee to go on record as desiring to extend these provisions longer than just through the end of the first quarter of next year. And whatever way we can do that without having an actual estimate of how much it would cost, it obviously would be less if your estimate is $5 billion, and then you subtract the savings from WOTC and it is somewhat less than that. So it is something that we can afford to do if we want to do it.

Chairman Baucus. Is there any other discussion on the amendment?

Senator Bunning. Please?

Chairman Baucus. First, I would hope the Senator would not press his amendment. Number one, it is out of order. Number two, there will be other opportunities to

deal with these issues. I just urge the Senator not to press his amendment. If he will withhold his amendment and try to work out some way to deal with this at some later date, then that would be preferable. But it is out of order.

Senator Kyl. And that is because?

Chairman Baucus. It is not paid for.

Senator Kyl. Because we do not have an estimate, because we could not get an estimate. So we do not know for sure that it is not paid for.

Chairman Baucus. Well, as of this moment it is not paid for.

Senator Kyl. Yes. I will accept the Chairman's best guess, that probably--

Chairman Baucus. As agreed to by the Senator.

Senator Kyl. I am sorry?

Chairman Baucus. You agreed to it. It is not paid for.

Senator Kyl. I understand that whatever increased cost there might be, which we do not know, is not paid for because I have not offered anything except the savings from WOTC. I acknowledge the Chairman is probably correct, that there is, therefore, a differential. But we do not know what that is.

Chairman Baucus. I would just hope the Senator

would not push his amendment so we can work on this and work it out.

Senator Kyl. Well, if we can commit ourselves to trying to extend the benefits for small business at least to the 2010 date, then obviously I am willing to do that. But because the committee has talked so much about wanting to help the small businesses, I think it is a logical thing for us to go on record as saying, that we would like to try to accomplish that.

Chairman Baucus. I hope, again, that the Senator would withdraw, but as Chair I cannot make a commitment that we are going to get the date changed, before we get to the floor, to 2010. That would be a breach of faith if I were to make that commitment.

I will say that I will work with the Senator. I understand the Senator's concerns. I just think that, all things considered, discretion would be the better part of valor, and it would be more appropriate if the amendment were not pushed to a vote at this point so we can work out those issues.

Other comments?

Senator Stabenow. Mr. Chairman?

Senator Bunning. Mr. Chairman?

Chairman Baucus. The Senator from Michigan first sought recognition.

Senator Stabenow. Thank you, Mr. Chairman. I would hope, also, that our colleague would withhold on this amendment. We are basically being asked to pass something that is not paid for and, at least on the surface, will be adding to a debt we are all trying to bring down.

Second, when we look at this, so many of us have talked about small business health care. If we are going to add another $5 billion or more as it relates to a package, I certainly would want to be given the opportunity to talk about small business health care as a priority in that process.

It seems to me we have agreed to something that is balanced and bipartisan, and to go further opens up, I think, other questions for those of us who would like to use an additional $5 billion in a different way at this point.

I would also just add that this started out as raising the minimum wage and focusing on workers, regardless of what size business they work in as well. For all of the folks that are working hard every day, trying to make it, I hope we are going to also keep a priority on the fact that this is about jobs as well.

Senator Bunning. Mr. Chairman?

Chairman Baucus. Senator Grassley?

Senator Grassley. I will let him go first, then I will.

Chairman Baucus. Senator Bunning?

Senator Bunning. Thank you. I would like to speak in favor of Senator Kyl's amendment because I support the Work Opportunity Tax Credit, just like everybody else here. But I think to put the bill in a better balance, we would need this type of an amendment to do that.

I agree that we do not know the exact cost, but I believe that the Senator from Michigan misspoke when she said it would add $5 billion to the cost, when our staff does not even have an idea of what the savings would be for the two years that WOTC was not included, and the additional cost in moving the depreciation and expensing provisions.

I think the thrust of the bill and the thrust of what we are trying to do, is to assist the small business people. What WOTC does, is include some people in my State, very big businesses that use it constantly, like Yum Brands and other people that are very, very familiar with the WOTC provisions. But they use them and they are a huge business.

I do not want to discriminate against them, but I do want to help the people that need the expensing and the other provisions that are included because they are going

to pay more minimum wages than those people at Yum Brands and other fast-foods do presently. So, I support Senator Kyl's amendment and would ask for its consideration.

Chairman Baucus. Senator Grassley?

Senator Grassley. Yes. I deferred temporarily to the Senator from Kentucky.

I think that there are several things to think about here. First of all, I think the Chairman is right, that it would be wrong for him to give a clear indication that he could work something out that maybe would bring it around exactly to where Senator Kyl would like to have it between now and the floor, or after we get to the floor.

But that does not preclude opportunities to improve along the lines of what Senator Kyl would like to do, if we have the proper offsets, and we can still maintain the bipartisan nature of it. So the Chairman has left that open. He still even left open beyond what I just said, but he cannot make any promises.

The other thing I think that we have to consider, is we do have a package put together here that I think is going to move and going to be beneficial to small business, although not as beneficial as if I were the Chairman of the committee and I was writing it, but it is still very beneficial. [Laughter].

We have got to face the minimum wage bill that is

going to be there, so we know that is something we have to be ready for and to minimize the impact upon small business.

Then if we go down the road of dealing with this right now and it encourages the Senator from Michigan to move ahead, I can see a lot of things that they might suggest for offsets that we not only do not like politically, but we would consider very wrong, very harmful to the economy if you consider the tax policies that we have adopted thus far that Chairman Greenspan said has revitalized the economy, to create seven million new jobs and bring in almost $600 billion more into the Treasury in enhanced revenue because of how the economy grows. We surely do not want to jeopardize that.

I know there are a lot of people on the other side of the aisle--maybe not all on this committee--who question whether our tax policies are wise. So I would hope we could move to the floor.

Senator Baucus and I will visit with Senator Kyl, the Senator from Kentucky, and others and see if we can do more--we have got to have offsets for what we do--and just see if we cannot move it along. We ought to move this bill to the floor and be ready when the small business provisions come up. So, I would hope that we could do that.

Chairman Baucus. Senator Kyl?

Senator Kyl. Thank you, Mr. Chairman.

First, let me ask unanimous consent to put in the record here a *Wall Street Journal* editorial of today that talks about surging revenues and the fact that our budget deficit is not something that was the concern that it was a few years ago, if I could get that inserted in the record.

Chairman Baucus. Without objection.

[The editorial appears in the appendix.]

Senator Kyl. And, second, I appreciate both your comments and the comments of--I keep wanting to say Chairman Grassley.

Senator Grassley. Sounds good. [Laughter].

Senator Kyl. The former Chairman of the committee, our colleague from Iowa.

Third, I do appreciate the fact that at least some prior discussion, and this morning, has continued to verify that it is important, and the committee recognizes the importance, of assisting the small businesses that are going to have to bear the brunt of the expenses of the minimum wage increase. I think that is an important achievement here.

Finally, what I would ask, Mr. Chairman, is this. Would it be possible for us, so that we do not have to

put Senators on the record voting against a particular amendment like the one that I offered, to simply ask if it would be possible to have the sense of this committee that our goal would be, along with the assurances that you and the former Chairman have made to try to work together on this, to try to extend these small business provisions beyond the first quarter of next year, if that is at all possible?

Would the committee at least be willing to agree that it is our desire to try to achieve that result so that you and Senator Grassley, and those of us who would want to work on this would at least have some guidance as to where we would be trying to get?

Chairman Baucus. Well, this reminds me of the debate and discussion on extenders, generally. It came down to, about three months before they expired, are we going to extend, are we not going to extend.

Many people who had been the beneficiaries of those extenders keep asking us, is it going to happen, is it not going to happen. But for one instance, I think, if my memory serves me correctly, we always had extended. So these provisions will be extended.

I might add in that regard, one reason why a very small business might not use WOTC very much, is because they do not have the float that big business has. They

are not sure WOTC is going to be around, so they do not have the opportunity to use it as much, which is an argument for making WOTC for small business, if not permanent, at least many years. That would be a real small business provision, extending WOTC so small business can plan ahead.

I do not know how wise it would be for me to set the precedent for this committee to pass out a lot of resolutions on one issue or another. I would have to give a little thought to that before I think we go down the road of passing out resolutions, not knowing what we are going to get ourselves into.

Senator Kyl. Well, Mr. Chairman, I was trying to accommodate your desire that we not have an actual vote on the proposed amendment, and I thought it would be beneficial if you had the sense from the committee, if at all possible--I mean, this is a loophole big enough to drive a truck through.

But if at all possible, it would be the sense of the committee that we do try to extend, beyond the first quarter of next year, the small business tax provisions. I think that is a fairly reasonable request. If my colleagues are not willing to express themselves on that, then I am not sure how aggressive you are going to be in trying to work with us to try to push that forward.

Chairman Baucus. Sure. I will be aggressive. The Senator always has the right--

Senator Kyl. And by the way, I know that the Chairman would like to do more on this. I am aware of that, so I am not suggesting that the Chairman himself would not like to extend these provisions. I think you and I have talked and I am persuaded that you would like to do that.

Chairman Baucus. The Senator always has his right to modify his amendment, too. For example, if the Senator wished to do so, the amendment could be modified to say, extend the provisions--leasehold improvement in this case--for as many months as cutting back WOTC would pay for.

That could be something the Senator could propose. Or a sense of the Senate in the same regard, or a sense of the committee on the same subject. That would void the issue of a pay-for.

What would your sense of the Senate be again, just so it is clear?

Senator Kyl. We could, of course, do exactly what you are talking about as part of this. It would just be the sense of the committee that the small business provision should be extended beyond the dates contained in the mark. One way of doing that would be--

Chairman Baucus. I think we would adopt that. Just adopt it.

Senator Grassley. But you have got to remember, that is going to fall far short. Far short.

Senator Kyl. Of 2010.

Senator Grassley. It is probably not going to do as much as if you worked with the Chairman to try to work something out on the floor.

Senator Kyl. That is why I am suggesting that if we can agree that we want to extend them beyond the dates contained in the mark, that is perhaps a more open-ended and more helpful solution.

Chairman Baucus. So the Senator is offering a resolution, not an amendment?

Senator Kyl. Yes. Correct.

Chairman Baucus. All right. Fine. Is there any objection to the resolution?

[No response]

Chairman Baucus. The Senator from Michigan?

Senator Stabenow. Thank you, Mr. Chairman. I would just like to go on record wanting to increase the length of time of the Work Opportunity Tax Credit. I am very uncomfortable.

I appreciate what the Chairman is doing, but again, we have a balanced package. I think the Chairman raised

a really important point about small businesses having certainty on WOTC, and the staff indicated that the majority of individuals--not the majority of dollars, but the majority of individuals--that were receiving the credit were in small businesses.

Chairman Baucus. Seeing no other Senators wishing to seek recognition or offer amendments, is there a motion on the mark?

Senator Grassley. Mr. Chairman, I would move the mark.

Chairman Baucus. Those in favor, say aye.

[Chorus of ayes]

Chairman Baucus. Those opposed, no.

[No response]

Chairman Baucus. The ayes have it. The mark is ordered reported. I ask consent that the staff be granted authority to make technical and conforming changes. Without objection, it is so ordered.

[No response]

Chairman Baucus. Does any Senator wish a roll call vote on the package?

[No response]

Chairman Baucus. Seeing none, none is requested. The mark is reported out and the committee is adjourned.

[Whereupon, at 11:39 a.m. the meeting was concluded.]

I N D E X

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STATEMENT OF:

THE HONORABLE MAX BAUCUS
A United States Senator
from the State of Montana 3

THE HONORABLE CHARLES E. GRASSLEY
A United States Senator
from the State of Iowa 6

Gilmour
73 pp.
1-17-07

UNITED STATES SENATE
COMMITTEE ON FINANCE
Max Baucus, Chairman

January 17, 2007
10:00 a.m.
215 Dirksen Senate Office Building

Agenda for Organizational Meeting
Committee on Finance
110th Congress

I. Organizational Matters

- Committee Rules
- Appointments to Joint Committee on Taxation
- Appointments to Congressional Trade Advisors on Trade Policy and Negotiations
- Appointments to the Congressional Oversight Group

II. An Original Bill entitled, "The Small Business and Work Opportunity Act of 2007"

Designation of Members to Serve on the Joint Committee on Taxation

Max Baucus
John D. Rockefeller, IV
Kent Conrad
Charles E. Grassley
Orrin G. Hatch

Designation of Members to Serve on the Congressional Trade Advisors on Trade Policy and Negotiations

Max Baucus
John D. Rockefeller, IV
Kent Conrad
Charles E. Grassley
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Designation of Members to Serve on the Congressional Oversight Group

Max Baucus
John D. Rockefeller, IV
Kent Conrad
Charles E. Grassley
Orrin Hatch

II. EXCERPTS FROM THE STANDING RULES OF THE SENATE RELATING TO STANDING COMMITTEES

RULE XXV

STANDING COMMITTEES

1. The following standing committees shall be appointed at the commencement of each Congress, and shall continue and have the power to act until their successors are appointed, with leave to report by bill or otherwise on matters within their respective jurisdictions:

* * *

(i) **Committee on Finance,** to which committee shall be referred all proposed legislation, messages, petitions, memorials, and other matters relating to the following subjects:

1. Bonded debt of the United States, except as provided in the Congressional Budget Act of 1974.
2. Customs, collection districts, and ports of entry and delivery.
3. Deposit of public moneys.
4. General revenue sharing.
5. Health programs under the Social Security Act and health programs financed by a specific tax or trust fund.
6. National social security.
7. Reciprocal trade agreements.
8. Revenue measures generally, except as provided in the Congressional Budget Act of 1974.
9. Revenue measures relating to the insular possessions.

10. Tariffs and import quotas, and matters related thereto.
11. Transportation of dutiable goods.

* * *

RULE XXVI

COMMITTEE PROCEDURE

* * *

2. Each committee shall adopt rules (not inconsistent with the Rules of the Senate) governing the procedure of such committee. The rules of each committee shall be published in the Congressional Record not later than March 1 of the first year of each Congress, except that if any such committee is established on or after February 1 of a year, the rules of that committee during the year of establishment shall be published in the Congressional Record not later than sixty days after such establishment. Any amendment to the rules of a committee shall not take effect until the amendment is published in the Congressional Record.

* * *

5. (a) Notwithstanding any other provision of the rules, when the Senate is in session, no committee of the Senate or any subcommittee thereof may meet, without special leave, after the conclusion of the first two hours after the meeting of the Senate commenced and in no case after two o'clock post meridian unless consent therefor has been obtained from the majority leader and the minority leader (or in the event of the absence of either of such leaders, from his designee). The prohibition contained in the preceding sentence shall not apply to the Committee on Appropriations or the Committee on the Budget. The majority leader or his designee shall announce to the

Senate whenever consent has been given under this subparagraph and shall state the time and place of such meeting. The right to make such announcement of consent shall have the same priority as the filing of a cloture motion.

(b) Each meeting of a committee, or any subcommittee thereof, including meetings to conduct hearings, shall be open to the public, except that a meeting or series of meetings by a committee or a subcommittee thereof on the same subject for a period of no more than fourteen calendar days may be closed to the public on a motion made and seconded to go into closed session to discuss only whether the matters enumerated in clauses (1) through (6) would require the meeting to be closed, followed immediately by a record vote in open session by a majority of the members of the committee or subcommittee when it is determined that the matters to be discussed or the testimony to be taken at such meeting or meetings—

(1) will disclose matters necessary to be kept secret in the interests of national defense or the confidential conduct of the foreign relations of the United States;

(2) will relate solely to matters of committee staff personnel or internal staff management or procedure;

(3) will tend to charge an individual with crime or misconduct, to disgrace or injure the professional standing of an individual, or otherwise to expose an individual to public contempt or obloquy, or will represent a clearly unwarranted invasion of the privacy of an individual;

(4) will disclose the identity of any informer or law enforcement agent or will disclose any information relating to the investigation or prosecution of a criminal of-

fense that is required to be kept secret in the interests of effective law enforcement;

(5) will disclose information relating to the trade secrets of financial or commercial information pertaining specifically to a given person if—

(A) an Act of Congress requires the information to be kept confidential by Government officers and employees; or

(B) the information has been obtained by the Government on a confidential basis, other than through an application by such person for a specific Government financial or other benefit, and is required to be kept secret in order to prevent undue injury to the competitive position of such person; or

(6) may divulge matters required to be kept confidential under other provisions of law or Government regulations.

(c) Whenever any hearing conducted by any such committee or subcommittee is open to the public, that hearing may be broadcast by radio or television, or both, under such rules as the committee or subcommittee may adopt.

(d) Whenever disorder arises during a committee meeting that is open to the public, or any demonstration of approval or disapproval is indulged in by any person in attendance at any such meeting, it shall be the duty of the Chair to enforce order on his own initiative and without any point of order being made by a Senator. When the Chair finds it necessary to maintain order, he shall have the power to clear the room, and the committee may act in closed session for so long as there is doubt of the assurance of order.

(e) Each committee shall prepare and keep a complete transcript or electronic recording adequate to fully record the proceeding of each meeting or conference whether or not

such meeting or any part thereof is closed under this paragraph, unless a majority of its members vote to forgo such a record.

* * *

DESCRIPTION OF THE CHAIRMAN'S MARK OF THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007"

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on January 17, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

January 12, 2007
JCX-3-07

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on January 17, 2007, of the "Small Business and Work Opportunity Act of 2007." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Mark.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of the "Small Business and Work Opportunity Act of 2007"* (JCX-3-07) January 12, 2007.

I. SMALL BUSINESS PROPOSALS

A. Extension of Increased Expensing for Small Business

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]

Description of Proposal

The proposal 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.

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

B. Fifteen-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Improvements and New Restaurant Buildings

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). 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

[6] Sec. 168.

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.

Description of Proposal

The present-law provisions for 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 proposal 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

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]

Description of Proposal

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 proposal, 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

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[7] Sec. 168.

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

[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 proposal.

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 proposal, while those in other industry classes do not qualify under the proposal.

Effective Date

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

D. Expand Eligibility for Cash Method of Accounting

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 being duplicated or omitted by reason of the change.[14] Positive adjustments (i.e., additions to

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[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.

[14] Sec. 481.

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]

Description of Proposal

Under the proposal, 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 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 proposal 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 proposal is applicable to taxable years beginning after the date of enactment.

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

[16] Ibid.

E. Work Opportunity Tax Credit

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)[17] 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.

[17] The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006 (Pub. L. 109-432).

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.

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 and before January 1, 2013. 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. Subchapter S Provisions

1. Capital gain not treated as passive investment income

Present Law

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.

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 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.

Description of Proposal

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.[18]

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.[19] 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.[20]

Description of Proposal

Under the provision, restricted bank director stock is not taken into account as outstanding stock in applying the provisions of subchapter S.[21] 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

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[18] 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).

[19] 12 U.S.C. secs. 71-72.

[20] 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.

[21] No inference is intended as to the proper tax treatment under present law.

Insurance Act), registered with the Federal Reserve System, 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.[22] 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.[23]

Positive adjustments (i.e., additions to taxable income) are generally spread over four taxable years beginning in the year of change.[24] Negative adjustments (i.e., reductions to taxable income) are generally taken into account entirely in the year of change.[25]

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.

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

[23] Sec. 481.

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

[25] Id.

Description of Proposal

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 disposition 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,[26] 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[27] 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 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.

Description of Proposal

The provision provides that where the disposition of stock of a QSub results in the termination of the QSub election, the disposition is treated as a disposition of an undivided interest in the assets of the QSub (based on the percentage of the stock disposed of) 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.

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

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

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.

Description of Proposal

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.

Description of Proposal

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.

G. Treatment of Professional Employer Organizations as Employers

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").[28]

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.

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.[29]

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

[29] Secs. 6011 and 6051.

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.[30] 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.[31] In addition, various definitions and special rules apply to certain types of employers.[32]

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.[33] 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 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.[34]

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

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

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

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

[34] 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.

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.[35] In addition, an employer may designate a reporting agent to be responsible for FICA tax and income tax withholding compliance,[36] including filing employment tax returns and issuing Forms W-2 to employees.[37] In that case, the reporting agent and the employer are jointly and severally liable for compliance.[38]

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 arrangement provide that the professional employer organization is the employer of the employees and is responsible for paying the employees and for the related employment tax compliance. The customer typically pays the professional employer organization a fee based on payroll costs plus an additional amount.[39]

In some cases, the employees provided to work in the customer's business are legally the employees of the customer, and the customer is legally responsible for employment tax

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[35] 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).

[36] The designated reporting agent rules do not apply for purposes of FUTA compliance.

[37] Sec. 3504. Form 2678 is used to designate a reporting agent.

[38] For administrative convenience, an employer may also use a payroll service to handle payroll and employment tax filings on its behalf, but the employer, not the payroll service, continues to be responsible for employment tax compliance.

[39] A professional employer organization may also provide employees with employee benefit coverage, such as under a pension plan or a health plan, even if the customer does not maintain such a plan. In such a case, the fee paid by the customer also covers employee benefit costs.

compliance. Nonetheless, customers generally rely on the professional employer organization for employment tax compliance (without designating the professional employer organization as a reporting agent) and treat the employees as employees of the professional employer organization.

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.[40] 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.[41] 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.[42]

Reporting by large food and beverage establishments

Certain reporting requirements relating to tips apply to large food or beverage establishments.[43] 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.

User fees

User fees apply to requests to the IRS for ruling letters, opinion letters, determination letters, and similar requests.[44] 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.

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[40] 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).

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

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

[43] Sec. 6053(c).

[44] Sec. 7528.

Description of Proposal

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

Under the proposal, if certain requirements are met, 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 purposes with respect to remuneration remitted by the certified professional employer organization to a work site employee.

Under the proposal, 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 proposal 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.

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 proposal does not apply in the case of a customer who is related to the certified professional employer organization.[45] 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.

As discussed more fully below, a work site employee is an individual who performs services (1) for a customer pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements and (2) at a work site that

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[45] 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.

meets certain requirements. Thus, if the contract or work site fails to meet these requirements, the individual is not a work site employee. The proposal applies also in the case of 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 specified requirements. In this case, 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. 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 proposal continue to apply.

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.

Except to the extent necessary for purposes of the proposal treating a certified professional employer organization as the employer for employment tax purposes, nothing in the proposal is to be construed to affect the determination of who is an employee or employer for purposes of the Code.

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 proposal, 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 proposal 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.[46] 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).[47]

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--

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[46] 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).

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

- 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
- 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.[48]

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 proposal. The Secretary is also directed to develop reporting and recordkeeping rules, regulations, and procedures to ensure compliance with the proposal 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 proposal, 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.

Other rules

Income tax credits based on wages for employment tax purposes

Under the proposal, for purposes of various income tax credits[49] 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

[48] 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.

customer (and not the certified professional employer organization) is to take into account wages 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.[50]

Reporting by large food and beverage establishments

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

No inference as to effect of proposal

Nothing contained in the proposal or the amendments made by the proposal 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 proposal), or (2) for purposes of any other provision of law.

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[49] 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.

[50] 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 proposal does not affect the application of these rules.

Effective Date

The proposal 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 proposal. The Secretary is directed to establish the certification program for professional employer organizations not later than six months before the proposal becomes effective.

JOINT COMMITTEE ON TAXATION
January 12, 2007
JCX-4-07

ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S MARK OF THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007," SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JANUARY 17, 2007

Fiscal Years 2007 - 2016

[Millions of Dollars]

Provision	Effective	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-11	2007-16
Small Business Proposals													
1. Extension of increased expensing for small business - increase section 179 expensing from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and extend indexing of both the deduction limit and the phaseout threshold (sunset 12/31/10)	tyba 12/31/09	---	---	---	-2,964	-1,897	1,732	1,092	792	613	375	-4,861	-257
2. Extension of the 15-year straight-line cost recovery period for qualified leasehold and restaurant improvements (sunset 3/31/08)	ppisa 12/31/07	---	-30	-88	-114	-112	-109	-100	-95	-100	-98	-345	-847
3. 15-year recovery period for new restaurant buildings (sunset 3/31/08)	ppisa DOE	-22	-66	-94	-99	-99	-98	-97	-95	-93	-86	-379	-847
4. 15-year recovery period for retail improvements (sunset 3/31/08)	ppisa DOE	-22	-76	-119	-127	-123	-114	-106	-108	-109	-108	-467	-1,012
5. Increase gross receipts threshold for cash accounting to $10M regardless of inventories, index for inflation, and reset testing period	tyba DOE	-9	-278	-151	-52	-57	-63	-69	-76	-84	-92	-547	-931
6. Extension of Work Opportunity Tax Credit with expansions on post 9/11 disabled veterans, high-risk youth, and vocational rehabilitation referrals (sunset 12/31/12)	wpoifibwa 12/31/07	---	-150	-411	-569	-657	-726	-591	-302	-143	-75	-1,788	-3,624
7. Subchapter S provisions													
a Exclude capital gains from passive investment income..	tyba DOE	---	-15	-30	-32	-34	-35	-37	-40	-43	-46	-111	-312
b. Treatment of qualifying director shares	tyba 12/31/06	-4	-10	-14	-18	-20	-21	-22	-23	-23	-23	-66	-178
c. Recapture of bad debt reserves	tyba 12/31/06	11	27	-22	-40	-36	-23	-21	-22	-23	-24	-60	-173
d. Treatment of sale of interest in a qualified subchapter S subsidiary	tyba 12/31/06	-1	-3	-3	-4	-4	-4	-5	-5	-5	-6	-15	-40
e. Elimination of all earnings and profits attributable to pre-1983 years	tyba DOE	-3	-2	-2	-2	-2	-2	-2	-2	-2	-2	-11	-21
f. Expansion of qualifying beneficiaries of an electing small business trust	DOE	---	-1	-2	-3	-4	-4	-4	-5	-5	-5	-10	-33
8. Treatment of certified professional employer organizations as employers	[1]	---	---	-2	-3	-4	-4	-4	-5	-5	-6	-8	-32
NET TOTAL		**-50**	**-604**	**-938**	**-4,027**	**-3,049**	**529**	**34**	**14**	**-22**	**-196**	**-8,668**	**-8,307**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be April 1, 2007.

Legend for "Effective" column:
DOE = date of enactment
ppisa = property placed in service after
tyba = taxable years beginning after
wpoifibwa = wages paid or incurred for individuals beginning work after

[1] 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.

Summary
Small Business and Work Opportunity Act of 2007
January 17, 2007

Small Business Tax Provisions

I. General Provisions

Section 179 Small Business Expensing. In lieu of depreciation, small business taxpayers may elect to deduct (or expense) the cost of qualified assets (or property) they purchase in the year when the assets are placed in service, within certain limits. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003, the amount that small businesses may expense under section 179 was increased from $25,000 to $100,000 for tax years beginning after 2002 through the end of 2005 and indexed for inflation. The American Jobs Creation Act of 2004 extended a slightly expanded version of small business expensing (with higher phase-out levels for small business) through 2007. The Tax Increase Prevention and Reconciliation Act of 2005 extended that enhanced provision through the end of 2009. In 2007, small business taxpayers are allowed to expense $112,000 (indexed for inflation), and the phase-out threshold is $450,000 (indexed for inflation). The proposal extends the present-law rules for one year, through the end of 2010. The proposal is effective for taxable yeas beginning after December 31, 2009. *The proposal is estimated to cost $4.861 billion over five years and $257 million over ten years.*

Fifteen-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements and Qualified Restaurant Improvements. In the American Jobs Creation Act of 2004, Congress shortened the cost recovery of certain leasehold and restaurant improvements from 39 to 15 years for the remainder of 2004 and 2005. The Tax Relief and Health Care Act of 2006 extended this provision to property placed in service after December 31, 2005 through December 31, 2007. The proposal extends the present-law rules for qualified leasehold and restaurant improvements to March 31, 2008. The proposal generally applies to property placed in service after December 31, 2007. *The proposal is estimated to cost $345 million over five years and $847 million over ten years.*

Fifteen-Year Straight-Line Cost Recovery for Qualified New Restaurant Buildings. Section 168(e)(3)(E)(v) currently provides a 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 the 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. The proposal extends the 15-year recovery period for qualified restaurant improvements to new restaurant buildings. The proposal generally applies to property placed in service after the date of enactment. Repeal of the three-year rule for restaurant property is effective for property placed in service after the date of enactment. The proposal expires on March 31, 2008. *The proposal is estimated to cost $379 million over five years and $847 million over ten years.*

Fifteen-Year Straight-Line Cost Recovery for Qualified Retail Improvement Property. The proposal extends the 15-year recovery period for qualified leasehold improvements to improvements made by retailers who own their buildings. For purposes of the provision, qualified retail improvement property does not include any improvement for which expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. For purposes of this proposal, retail establishments that qualify for the 15-year recovery period include those with a physical store front open to the general public in order to sell tangible personal property and/or services. The proposal applies to property placed in service after the date of enactment. The proposal expires on March 31, 2008. *The proposal is estimated to cost $467 million over five years and $1.012 billion over ten years.*

Expand Eligibility for Cash Method of Accounting. Currently, cash method of accounting may not be used by any C corporation, 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. An exception is provided for C corporations and partnerships that have a C corporation as a partner is the average annual gross receipts in the three previous tax years do not exceed $5 million. In addition, companies that keep inventory must generally use the accrual method of accounting unless they have less than $1 million in gross receipts. Under cash method, income is recorded when it is received in the form of cash or its equivalent. Expenses generally are recorded when they are paid. Under accrual method, income and expenses typically are recorded when the transactions giving rise to them are completed, regardless of when cash is received or paid. The proposal permanently increases the threshold for the exception from $5 million to $10 million and indexes the threshold for inflation. This allowance would apply irrespective of whether inventories are maintained. The proposal is applicable to taxable years beginning after the date of enactment. *The proposal is estimated to cost $547 million over five years and $931 million over ten years.*

The Work Opportunity Tax Credit ("WOTC"). WOTC allows employers credits against wages for hiring individuals from one or more of nine targeted groups (such as recipients of public assistance, qualified veterans on assistance, and "high risk youth"). The proposal extends WOTC for five years (for qualified individuals who begin work for an employer after December 31, 2007 and before January 1, 2013). The proposal 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. In the case of individuals certified as entitled to compensation for a service-connected disability incurred after September 10, 2001, the proposal expands the definition of qualified first-year wages from $6,000 to $12,000. The proposal expands the definition of high risk youths to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. The proposal also changes the name of the category to the "designated community residents" targeted group. 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 and before January 1, 2013. 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. *The proposal is estimated to cost $1.788 billion over five years and $3.624 billion over ten years.*

Treatment of Professional Employer Organizations as Employers. The proposal creates a voluntary certification program for PEOs (CPEOs) that meet standards of solvency and responsibility and that maintain ongoing certification by the IRS. CPEOs would have to accept sole liability for the collection of Federal employment taxes with respect to workers ("worksite employees") performing services for PEO clients. Small or medium-sized business that contract with CPEOs would be assured they would not be liable for those taxes already paid to the PEO. The proposal does not affect the determination of whether or not an employer-employee relationship exists for any purpose other than liability for payroll tax deposits. The proposal 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 proposal. The Secretary is directed to establish the certification program for professional employer organizations not later than six months before the proposal becomes effective. *The proposal is to cost $8 million over five years and $32 million over ten years.*

II. Subchapter S Provisions

Capital Gain Not Treated as Passive Investment Income. An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excessive 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. 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. The proposal eliminates gains from sales or exchanges of stock or securities as an item of passive investment income. The proposal applies to taxable years beginning after the date of enactment. *The proposal is estimated to cost $111 million over five years and $312 million over ten years.*

Treatment of Bank Director Shares. 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. National and state banking laws require that a director of a bank own stock. In some cases, a bank enters into an agreement under which the bank (or 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. The proposal clarifies that qualifying director shares are not treated as a second class of stock for purposes of subchapter S. The proposal applies to taxable years beginning after December 31, 2006. *The proposal is estimated to cost $66 million over five years and $178 million over ten years.*

Treatment of Banks Changing from Reserve Method of Accounting. A financial institution which uses the reserve method of accounting for bad debts may not elect to be an S corporation. 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 change. These adjustments are subject two levels of taxation. The proposal allows a bank which changes from the reserve method of accounting for bad debts to elect to take into account all adjustments the year before it changes to an S corporation. Adjustments taken into account the year before the corporation changes to an S corporation are only subject to corporate-level taxation. The proposal applies to taxable years beginning after December 31, 2006. *The proposal is estimated to cost $60 million over five years and $173 million over ten years.*

Treatment of Disposition of an Interest in Qualified Subchapter S Subsidiary. If a subsidiary of an S corporation ceases to be a qualified subchapter S subsidiary ("QSub") the subsidiary is treated as a new corporation acquiring all its assets immediately before such cessation from the parent S corporation in exchange for its stock. The proposal provides that where the disposition of stock of a QSub results in the termination of the QSub election, the disposition is treated as a disposition of an undivided interest in the assets of the QSub (based on the percentage of the stock disposed of) followed by a deemed transfer to the QSub. The proposal applies to taxable years beginning after December 31, 2006. *The proposal is estimated to cost $15 million over five years and $40 million over ten years.*

Elimination of Earnings and Profits Attributable to Pre-1983 Years. The proposal 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 proposal 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. The proposal applies to taxable years beginning after the date of enactment. *The proposal is estimated to cost $11 million over five years and $21 million over ten years.*

Expansion of Qualifying Beneficiaries of an Electing Small Business Trust ("ESBT"). Under current law, an ESBT may be a shareholder of an S corporation. A nonresident alien may not be a shareholder of an S corporation, but may be a shareholder of a Limited Liability Corporation (LLC). The proposal provides some parity between S corporations and LLCs by allowing nonresident aliens to become a qualified beneficiary of an electing small business trust that owns S corporation stock. Current law treatment of nonresident aliens as non-qualified shareholders of an S corporation does not change. The proposal is effective on the date of enactment. *The proposal is estimated to cost $10 million over five years and $33 million over ten years.*

Offsets

Sale-In/Lease-Out (SILO) – Foreign. The provision disallows future losses on foreign tax exempt use property for leases entered into on or before March 12, 2004. A provision in the American Jobs Creation Act applied to leases entered into after March 12, 2004. In a foreign SILO transaction, a foreign government or other foreign entity that doesn't pay U.S. tax "sells" property, such as a subway or sewer, to a U.S. taxable investor and then "leases" the property back for use. The effect is to transfer depreciation deductions from the tax-exempt entity, which cannot use the deductions, to a taxable entity that can, with little economic risk. The proposal is effective for taxable years beginning after December 31, 2006. *The proposal is estimated to raise $4.273 billion over five years and $4.088 billion over ten years.*

Corporate Inversions. This proposal revises the corporate inversion effective date of section 7874 of the American Jobs Creation Act (AJCA) from the AJCA date of March 4, 2003 to March 20, 2002. Section 7874 was enacted to stop U.S. corporations and partnerships from using inversion transactions to escape U.S. tax on their earnings. Section 7874 applies to two types of inversion transactions that occurred after March 4, 2003. In the first type of transaction, a U.S. corporation becomes a subsidiary of a foreign-incorporated entity and the former shareholders of the U.S. corporation own 80 percent or more of the foreign-incorporated entity (an "80-percent inversion'). These foreign-incorporated entities are treated as U.S. corporations for all U.S. income tax purposes. In the second type of transaction, former shareholders of the U.S. corporation own 60 percent or more, but less than 80 percent, of the foreign-incorporated entity. In these transactions, the foreign-incorporated entity is treated as foreign, but any applicable corporate-level "toll-charge" taxes are not offset by tax attributes such as net operating losses or foreign tax credits. Section 7874 also applies inversion transactions involving certain partnerships. An exception applies for transactions that were substantially completed prior to March 4, 2003. Under this provision section 7874 would apply to treat foreign corporations as U.S. corporations if they completed an 80-percent inversion after March 20, 2002 but on or before March 4, 2003, subject to the same exception for substantially completed transactions that is contained in present law. The proposal is effective for tax years beginning after December 31, 2006. *It is estimated to raise $449 million over five years and $1.153 billion over ten years.*

Deny Deduction for Punitive Damages. This provision eliminates the deduction for punitive damages, including torts, that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. Payments made by insurance companies for punitive damages are included in the gross income of the insured person and the insurer is required to report the amount paid to both the insured person and the IRS. The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment. *The proposal is estimated to raise $130 million over five years and $299 million over ten years.*

Denial of Deduction for Certain Fines, Penalties, and Other Amounts. This provision clarifies that amounts paid or incurred in connection with civil settlements to or at the direction of a government for the violation of any law or the potential violation of law are not deductible for Federal income tax purposes. Amounts for restitution or remediation are deductible. Government agencies are required to notify the IRS of settlements. The provision would be effective for amounts paid or incurred on or after the date of enactment unless paid under a binding order or agreement entered before that date. *The proposal is estimated to raise $172 million over five years and $244 million over ten years.*

Impose Mark to Market on Individuals Who Expatriate. This provision applies to certain U.S. citizens who relinquish their U.S. citizenship and certain long-term residents who terminate their U.S. residency. The proposal generally taxes these individuals on the net unrealized gain in their property as if such property were sold for fair market value. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency), and it is taken into account at the time of expatriation without regard to other tax code provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the tax code. In addition, the exclusion from income for the value of property acquired by gift or inheritance does not apply to the value of any property received from a covered expatriate. This provision is generally effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of enactment. *The proposal is estimated to raise $220 million over five years and $417 million over ten years.*

Deferred Compensation. The annual deferral on behalf of an individual to nonqualified deferred compensation arrangements of an employer is limited to the lesser of $1 million or the average taxable compensation for the previous five years. Failure to comply will result in ordinary income tax and the penalties applicable to other failures to comply with deferral rules. The provision applies to taxable years beginning after December 31, 2006; however, earlier years will be taken into account for purposes of computing the five-year average. *The proposal is estimated to raise $307 million over five years and $806 million over ten years.*

Increase in Certain Criminal Penalties. The provision increases the criminal penalties for tax evasion and failure to file. It also institutes an "aggravated" failure to file penalty that is a felony when there is a failure to file for at least three years. It applies to actions and failures to act after the date of enactment. *The proposal is estimated to raise $1 million over five years and $5 million over ten years.*

Doubling of Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements. The proposal 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 proposal applies to taxpayers who did not voluntarily disclose such arrangements through the IRS Offshore Voluntary Compliance Initiative, or who do not otherwise disclose. The provision applies to open tax years on or after the date of enactment. *The proposal is estimated to raise $5 million over five years and $10 million over ten years.*

Increase in Penalty for Bad Checks and Money Orders. For bad checks or money orders paid to the IRS of less than $1,250, the penalty is raised to the lesser of $25 or the amount of the check or money order. This is an increase from the current threshold of less than $750 and $15. For amounts of $1,250 or more, the penalty remains at 2 percent of the check amount. It is effective to checks or money orders received on or after the date of enactment. *The proposal is estimated to raise $10 million over five years and $20 million over ten years.*

Modify the Tax Treatment of Contingent Payment Convertible Debt Instruments. The provision creates a consistent "apples to apples" approach to value contingent convertible debt for purposes of computing original issue discount (OID). A "comparable rate" for a *contingent convertible* debt instrument would be based on a *non-contingent, convertible* debt instrument (instead of a non-convertible debt instrument, as the IRS now applies the law). It is effective for debt instruments issued on or after the date of enactment. *The proposal is estimated to raise $222 million over five years and $448 million over ten years.*

Extension of IRS User Fees. The proposal extends the statutory authorization of the IRS to impose user fees for two additional years, through 9/30/16. The authorization was extended through 2014 in the American Jobs Creation Act. The provision is effective for requests after 9/30/14. *It is estimated to raise $60 million over ten years.*

Amend Collection Due Process Procedures for Employment Tax Liabilities. Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. 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. Under the proposal, levies issued to collect Federal employment taxes are excepted from the pre-levy CDP hearing requirement. Taxpayers have full rights after the CDP hearing. This provision applies to levies issued on or after 120 days after the date of enactment. *The proposal is estimated to raise $156 million over five years and $271 million over ten years.*

Whistleblower Reforms. The Code currently authorizes the IRS to pay reward money for information received from whistleblowers. The reward amount varies based on the type of information and the amount of proceeds actually collected. The proposal expands whistleblower reforms enacted in H.R. 6408, the Tax Relief and Health Care Act of 2006, by requiring the establishment of a Whistleblower Office that is responsible for monitoring information received from informants and determining amounts to be awarded. It applies to deficiencies exceeding $20,000 and, in the case of individuals, incomes exceeding $200,000. This provision applies to information provided on or after the date of enactment. *The proposal raises $77 million over five years and $402 million over ten years.*

Modify Definition of Covered Employee. The proposal modifies the definition of a covered employee to include (1) any individual who was the Chief Executive Officer of the company at any time during the taxable year; (2) the four officers with the highest compensation for the year; and (3) any individual who was previously a covered employee with respect to the company (or a beneficiary of such person). The provision is effective for taxable years beginning after 12/31/06. *It is estimated to raise $20 million over five years and $105 million over ten years.*

DESCRIPTION OF THE CHAIRMAN'S MODIFICATION OF THE PROVISIONS OF THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007"

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on January 17, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

January 17, 2007
JCX-5-07

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the provisions of the "Small Business and Work Opportunity Act of 2007," which is to be marked up by the Senate Committee on Finance on January 17, 2007.[2]

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "Small Business and Work Opportunity Act of 2007"* (JCX-5-07) January 17, 2007.

[2] The provisions of the Chairman's mark are described in the Joint Committee on Taxation, *Description of the Chairman's Mark of the "Small Business and Work Opportunity Act of 2007"* (JCX-3-07), January 12, 2007.

I. MODIFICATION TO THE CHAIRMAN'S MARK

A. Modification to Treatment of Bank Director Shares (Item I.F.2 of the Chairman's Mark)

The requirement that a financial institution be registered with the Federal Reserve System in order for its stock to qualify as bank director shares is deleted.

II. PROPOSALS THAT RAISE REVENUE

A. Modification of Effective Date of Leasing Provisions of the American Jobs Creation Act of 2004

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").

Description of Proposal

The proposal changes the effective date of the loss deferral rules with respect to certain leases. Under the proposal, 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.

Effective Date

The proposal 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

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[3] 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.[4]

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.

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

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[3] 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.

[4] 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.

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.

Description of Proposal

The proposal 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 proposal (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 proposal, 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 proposal, including, but not limited to, regulations to prevent the avoidance of the purposes of the proposal.

Effective Date

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

C. Denial of Deduction for Punitive Damages

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.[5] 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.[6] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[7] 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.[8]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[9] However, this exclusion does not apply to punitive damages.[10]

Description of Proposal

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

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[5] Sec. 162(a).

[6] Sec. 162(c).

[7] Sec. 162(f).

[8] Sec. 162(g).

[9] Sec. 104(a).

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

D. Denial of Deduction for Certain Fines, Penalties, and Other Amounts

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."[11]

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.

Description 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 [12] are nondeductible under any provision of the income tax provisions.[13] 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

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[11] 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).

[12] 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.

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

required to come into compliance.[14] The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made.[15]

An exception also applies to any amount paid or incurred as taxes due.[16]

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.[17]

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.[18] 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.

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[14] 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).

[15] 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.

[16] 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).

[17] 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 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.

[18] 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.

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 may be required by Secretary. The report must separately identify any amounts that are restitution or remediation of property, or correction of noncompliance.[19]

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.[20]

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

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[19] 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.

[20] 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.

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.

E. Revision of Tax Rules on Expatriation of Individuals

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.[21]

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.

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

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

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[22] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[23] and individuals with minimal prior physical presence in the United States,[24] 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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[22] Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

[23] 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.

[24] 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.

Description of Proposal

In general

The proposal 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 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2005.

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 proposal 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 proposal 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 proposal, 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 proposal. 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 proposal.

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

The deemed sale rule of the proposal 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 proposal. Regulatory authority is granted to the Treasury to exempt other types of property from the proposal.

Under the proposal, 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 proposal, 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 proposal. 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 proposal 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).[25] However, the proposal contains a special rule for an interest in a "retirement plan." For purposes of the proposal, 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

Detailed rules apply under the proposal 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

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[25] Application of the proposal 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).

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.

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.[26] 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

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

contingencies and discretionary powers in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive).

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 proposal authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal. 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 proposal, 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 proposal provides a coordination rule with the present-law alternative tax regime. Under the proposal, 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 proposal.

Immigration rules

The proposal 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 proposal's expatriation tax rules (regardless of the subjective motive for expatriating). For this purpose, the proposal 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 proposal 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 proposal.

Effective Date

The proposal 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 proposal 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 proposal 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

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.[27] 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.

Description of Proposal

The proposal adds an additional requirement to the rules governing the income inclusion of amounts deferred under a nonqualified deferred compensation plan. Under the proposal, the annual aggregate amounts deferred under a nonqualified deferred compensation plan by an individual may not exceed the lesser of (1) $1 million or (2) the individual's annualized includible compensation. 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 proposal 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

[27] Code sec. 409A.

20-percent additional tax.[28] Aggregation rules apply as necessary to carry out the purposes of the proposal.

Annualized includible compensation is the average annual compensation for services performed for the employer sponsoring the deferred compensation plan (or a predecessor or related entity) that was includible in the individual's gross income for the five-year period preceding the year for which the limitation is being determined.[29] In the case in which an election to defer amounts is made, annualized includible compensation is the average annual compensation for services performed for the employer sponsoring the deferred compensation plan (or a predecessor or related entity) that was includible in the individual's gross income for the five-year period preceding the year in which the election to defer is made. The proposal applies to all amounts deferred under nonqualified deferred compensation plans (as defined under section 409A), including plans of both private and publicly-held corporations.

Earnings (whether actual or notional) attributable to nonqualified deferred compensation are treated as additional deferred compensation and are subject to the proposal. Earnings on amounts deferred in taxable years beginning before January 1, 2007, are not subject to the proposal. Future earnings (actual or notional) on amounts included in income under the proposal are includible in income as earned.

The proposal 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 proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The proposal provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the purposes of proposal.

Effective Date

The proposal is effective for amounts deferred in taxable years beginning after December 31, 2006. The proposal directs Treasury to issue guidance allowing existing outstanding deferral elections to be modified on or before December 31, 2007, in order to reduce deferrals for taxable years beginning after December 31, 2006, to the extent needed to comply with the proposal, without violating the requirements of section 409A.

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

[29] It is intended that annualized includible compensation is determined under rules similar to the rules relating to golden parachute payments (sec. 280G) except that no change in ownership or control is required.

G. Increase in Criminal Monetary Penalty Limitations for Fraud and Other Crimes

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,[30] $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.[31] For example, for an individual, the maximum 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.

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[30] 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).

[31] 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.

Description of Proposal

Attempt to evade or defeat tax

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

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

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

Effective Date

The proposal 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

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.[32]

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.[33] The IRS treats participation in the OVCI as a voluntary disclosure.[34]

Description of Proposal

The proposal 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 proposal applies to taxpayers who did not (or do not) voluntarily disclose such arrangements through the OVCI or otherwise. Under the proposal, 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,[35] 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 proposal if the use of the offshore financial arrangements is incidental to the transaction and, in

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

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

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

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

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

I. Increase in Penalty for Bad Checks and Money Orders

Present Law

The Code[36] 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).

Description of Proposal

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

[36] Sec. 6657.

J. Treatment of Contingent Payment Convertible Debt Instruments

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 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.[37] 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.[38] 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.[39]

In the case of contingent payment debt instruments that are issued for money or publicly traded property,[40] the regulations provide that interest on a debt instrument must be taken into 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,

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

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

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

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

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.[41]

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.[42] 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.

Description of Proposal

The proposal provides that, in the case of a contingent convertible debt instrument,[43] any Treasury regulations which require OID to be determined by reference to the comparable yield of 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 proposal, 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 proposal is effective for debt instruments issued on or after date of enactment.

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

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

[43] Under the proposal, 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.

K. Extension of IRS User Fees

Present Law

The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[44] These user fees are authorized by statute through September 30, 2014.

Description of Proposal

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

Effective Date

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

[44] Section 7528.

L. Modification of Collection Due Process Procedures for Employment Tax Liabilities

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.[45] Similar rules apply with respect to notices of tax liens, although the right to a hearing arises only on the filing of a notice.[46] 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").[47] 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.

Description of Proposal

Under the proposal, levies issued to collect Federal employment taxes are excepted from the pre-levy CDP hearing requirement. Thus, under the proposal, 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.

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[45] Sec. 6330(a).

[46] Sec. 6320.

[47] 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.

Effective Date

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

M. Whistleblower Reforms

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."[48] 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")[49] 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.

Description of Proposal

The proposal modifies the reward program established under the Act. Under the proposal, 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.

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[48] Sec. 7623.

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

The proposal 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 proposal requires the Secretary to report to Congress within six months of the date of enactment on the implementation of this proposal, including the operation of the Whistleblower Office and the implementation of the recommendations of the Treasury Inspector General for Tax Administration.[50]

Finally, the proposal authorizes the Tax Court to adopt rules to preserve the anonymity, privacy, or confidentiality of any person appealing the denial of an award determination or any person who is the subject of the enforcement action upon which the award determination is based.

Effective Date

The proposal is effective for information provided on or after the date of enactment.

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

N. Modify Definition of Covered Employee for Denial of Deduction for Excessive Employee Remuneration

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.[51] 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.[52]

Description of Proposal

The proposal modifies the definition of covered employee. Under the proposal, covered employees include any individual who was the Chief Executive Officer of the company at any time during the taxable year. In addition, covered employees include the four officers with the highest compensation for the year. Under the proposal, 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 (and beneficiaries of such persons). For example, 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 proposal is effective for taxable years beginning after December 31, 2006.

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[51] Sec. 162(m).

[52] 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).

JOINT COMMITTEE ON TAXATION
January 17, 2007
JCX-6-07

ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S MODIFICATION TO THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007," SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JANUARY 17, 2007

Fiscal Years 2007 - 2016

[Millions of Dollars]

Provision	Effective	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-11	2007-16
A. Tax Relief Provisions													
I. General Provisions													
1. Extension of increased expensing for small business - increase section 179 expensing from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and extend indexing of both the deduction limit and the phaseout threshold (sunset 12/31/10)	tyba 12/31/09	---	---	---	-2,964	-1,897	1,732	1,092	792	613	375	-4,861	-257
2. Extension of the 15-year straight-line cost recovery period for qualified leasehold and restaurant improvements (sunset 3/31/08)	ppisa 12/31/07	---	-30	-88	-114	-112	-109	-100	-95	-100	-98	-345	-847
3. 15-year recovery period for new restaurant buildings (sunset 3/31/08)	ppisa DOE	-22	-66	-94	-99	-99	-98	-97	-95	-93	-86	-379	-847
4. 15-year recovery period for retail improvements (sunset 3/31/08)	ppisa DOE	-22	-76	-119	-127	-123	-114	-106	-108	-109	-108	-467	-1,012
5. Increase gross receipts threshold for cash accounting to $10M regardless of inventories, index for inflation, and reset testing period	tyba DOE	-9	-278	-151	-52	-57	-63	-69	-76	-84	-92	-547	-931
6. Extension of Work Opportunity Tax Credit with expansions on post 9/11 disabled veterans, high-risk youth, and vocational rehabilitation referrals (sunset 12/31/12)	wpoifibwa 12/31/07	---	-150	-411	-569	-657	-726	-591	-302	-143	-75	-1,788	-3,624
7. Treatment of certified professional employer organizations as employers	[1]	---	---	-2	-3	-4	-4	-4	-5	-5	-6	-8	-32
II. Subchapter S Provisions													
1. Exclude capital gains from passive investment income	tyba DOE	---	-15	-30	-32	-34	-35	-37	-40	-43	-46	-111	-312
2. Treatment of qualifying director shares	tyba 12/31/06	-4	-10	-14	-18	-20	-21	-22	-23	-23	-23	-66	-178
3. Recapture of bad debt reserves	tyba 12/31/06	11	27	-22	-40	-36	-23	-21	-22	-23	-24	-60	-173
4. Treatment of sale of interest in a qualified subchapter S subsidiary	tyba 12/31/06	-1	-3	-3	-4	-4	-4	-5	-5	-5	-6	-15	-40
5. Elimination of all earnings and profits attributable to pre-1983 years	tyba DOE	-3	-2	-2	-2	-2	-2	-2	-2	-2	-2	-11	-21
6. Expansion of qualifying beneficiaries of an electing small business trust	DOE	---	-1	-2	-3	-4	-4	-4	-5	-5	-5	-10	-33
Total of Tax Relief Provisions		**-50**	**-604**	**-938**	**-4,027**	**-3,049**	**529**	**34**	**14**	**-22**	**-196**	**-8,668**	**-8,307**
B. Revenue Provisions													
1. Modify 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	tyba 12/31/06	1,018	1,662	896	407	290	288	260	135	-239	-629	4,273	4,088

Provision	Effective	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-11	2007-16
2. Tax treatment of inversion transactions	tyba 2006	42	86	99	107	115	123	123	143	153	162	449	1,153
3. Deny deduction for punitive damages	dpoio/a DOE	3	37	29	30	31	32	33	34	35	36	130	299
4. Denial of deduction for certain fines, penalties, and other amounts	generally apoio/a DOE	25	87	31	15	15	15	15	15	15	15	172	244
5. Impose mark-to-market on individuals who expatriate	[2]	13	57	54	50	46	43	41	39	38	36	220	417
6. Limitation on annual amounts which may be deferred under nonqualified deferred compensation arrangements [3]	tyba 12/31/06	43	59	60	63	83	94	97	100	103	106	307	806
7. Increase in certain criminal penalties	aaftaoa DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	1	5
8. Double certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements	oyo/a DOE	1	1	1	1	1	1	1	1	1	1	5	10
9. Increase in penalty for bad checks and money orders	comora DOE	2	2	2	2	2	2	2	2	2	2	10	20
10. Change the tax treatment of contingent convertible debt instruments	diio/a DOE	8	37	52	62	63	58	49	45	39	35	222	448
11. Extension of IRS user fees (sunset 9/30/16) [5]	ra 9/30/14	—	—	—	—	—	—	—	—	30	30	—	60
12. Modification of collection due process procedures for employment tax liabilities	lio/a 120da DOE	—	58	50	28	20	17	20	23	26	29	156	271
13. Modifications to Whistleblower reforms [6]	ipo/a DOE	1	6	15	23	32	42	51	63	79	90	77	402
14. Modify definition of covered employee for denial of deduction for excessive employee remuneration	tyba 12/31/06	1	3	4	5	7	10	14	18	20	23	20	105
Total of Revenue Provisions		**1,157**	**2,095**	**1,293**	**793**	**705**	**725**	**706**	**618**	**302**	**-64**	**6,042**	**8,328**
NET TOTAL		**1,107**	**1,491**	**355**	**-3,234**	**-2,344**	**1,254**	**740**	**632**	**280**	**-260**	**-2,626**	**21**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be April 1, 2007.

Legend for "Effective" column:

aaftaoa = actions and failures to act occurring after
apoio/a = amounts paid or incurred on or after
comora = checks or money orders received after
diio/a = debt instrument issued on or after
DOE = date of enactment
dpoio/a = damages paid or incurred on or after
oyo/a = open years on or after
ppisa = property placed in service after
ipo/a = information provided on or after
lio/a = levies issued on or after
tyba = taxable years beginning after
ra = requests after
wpoifibwa = wages paid or incurred for individuals beginning work after
120da = 120 days after

[1] 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.
[2] Generally effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after the date of enactment.
[3] Estimate assumes that changes to outstanding elections to reduce amounts deferred would be permissible.
[4] Gain of less than $500,000.
[5] Estimate provided by the Congressional Budget Office.
[6] Net of outlays.

NOT FOR PUBLIC DISTRIBUTION

Amendment List

Small Business and Work Opportunity Act of 2007

January 17, 2007

Committee Number	Senator	Summary	Offset
1	Bingaman #1	Health insurance premium payroll tax deduction for the self-employed	Offset to be determined
2	Bingaman/Smith #2	Hope Scholarship Credit	Offset to be determined
	Kerry #1	Expansion of qualified veterans eligible for the work opportunity tax credit	Denying the deduction for certain fines and penalties and denying the deduction for punitive damages
4	Kerry #2	Repeal the AMT preference for section 1202	The amendment includes offsets sufficient to ensure that the amendment is revenue neutral.
5	Lincoln #1	An amendment to enable small businesses to provide health benefits for their employees	To be provided
6	Lincoln #2	An amendment to provide tax relief for Employee Stock Ownership Plans	To be provided
7	Lincoln #3	An amendment to provide timber tax relief	To be provided
8	Schumer #1	To extend the Work Opportunity Tax Credit	The amendment's cost would be offset by adding the provision that changed the foreign tax credit rules for large integrated oil companies that are dual capacity taxpayers, which passed the Senate in February 2006 as part of the "Tax Relief Act of 2006." The provision was scored as saving $776 million at that time.
9	Schumer #2	To extend the Work Opportunity Tax Credit	Half of the amendment's cost would be offset by adding the provision that changed the foreign tax credit rules for large integrated oil companies that are dual capacity taxpayers, which passed the Senate in February 2006 as part of the "Tax Relief Act of 2006." The provision was scored as saving $776 million at that time. The rest of the offset will be provided at the appropriate time.

Amendment List

Small Business and Work Opportunity Act of 2007

January 17, 2007

10	Schumer #3	To provide capital gains tax relief to certain widows and widowers	The cost should be relatively small, but an official revenue estimate has not been received. An offset will be provided at the appropriate time.
11	Hatch/Lincoln/Schumer #1	Repeal excessive passive investment income as a termination event	To be provided
12	Hatch/Lincoln/Smith #2	Increase the threshold for taxing excess passive income from 25 percent to 60 percent	To be provided
13	Hatch #3	Add the provisions of S. 4030, the Real Estate Investment Trust Investment Diversification and Empowerment Act of 2006	To be provided
14	Hatch #4	Provide tax equity through credits equal to amount of payroll taxes paid on HSA eligible premiums and contributions	To be provided
15	Hatch #5	Allow High- Deductible Health Plan Premiums to be paid with Health Savings Accounts Funds	To be provided
16	Lott/Kyl #1	Extension of Section 179 increased expenses for small business through 12/31/2012	
17	Lott/Kyl #2	Extension of the 15 year straight-line cost recovery period for qualified leasehold and restaurant improvements	
18	Lott/Kyl #3	Extension of the 15 year recovery period for new restaurant buildings	
19	Lott/Kyl #4	Extension of the 15 year recovery period for retail improvements	
20	Snowe #1	Small Business Expensing	To be provided
21	Snowe/Lincoln #2	Small Business Tax Flexibility Act	To be provided
22	Snowe #3	SIMPLE Cafeteria Plan	To be provided
23	Kyl #1	Extend the three depreciation provisions and WOTC through 2010	
24	Thomas #1	An amendment to improve the operation of SIMPLE IRAs and 401(k)s and make retirement plans more accessible to small businesses and their employees	Offset to be provided
25	Thomas/Kyl #2	An amendment to extend all temporary tax relief provisions in the bill through 2012	Offset to be provided
26	Smith-Schumer #1	Domestic Partner Health Benefits Equity Act for the Self-Employed	To be provided
27	Smith #2	Start-up Credit for New Small Business Retirement Plan Contributions	To be provided
28	Smith #3	Equalization of Tax Treatment of Retirement Plan Contributions of the Self-Employed	To be provided
29	Smith #4	Modify the Top Heavy Rules for Deferral-Only 401(k) Plans	To be provided

Amendment List

Small Business and Work Opportunity Act of 2007

January 17, 2007

30	Smith #5	Amend Plan Document Compliance Rules for Small Business Retirement Plans	To be provided

1

Bingaman Amendment #1 to the Small Business and Work Opportunity Act of 2007

Short Title: Health insurance premium payroll tax deduction for the self-employed

Description of Amendment: This amendment would permit self-employed persons to deduct from payroll taxes amounts expended for health insurance. Unlike other businesses, self-employed persons cannot deduct the cost of health insurance when calculating their payroll tax liability. This amendment would eliminate this disparity by treating self-employed persons the same as other businesses.

Offset to be determined.

Chris Stone (4-4266)

2

Bingaman-Smith Amendment #2 to the Small Business and Work Opportunity Act of 2007

Short Title: Hope Scholarship Credit

Description of Amendment: This amendment would (1) expand the Hope Scholarship Credit to cover fees, books, supplies, equipment, and room and board, and (2) exempt Federal Pell Grants and Federal supplemental educational opportunity grants from expenses when calculating the amount of the Hope Scholarship Credit.

Offset to be determined.

Chris Stone (4-4266)

3

Kerry Amendment #1 to Small Business and Work Opportunity Act of 2007

Short Title: Expansion of qualified veterans eligible for the work opportunity tax credit

Description of Amendment: The mark expands the definition of qualified veterans eligible for the work opportunity tax credit (WOTC). Veterans that become disabled after September 10, 2001 would be eligible for WOTC. The amendment changes the date to January 15, 1991 in order to include veterans of the Persian Gulf War. The amendment would be offset by denying the deduction for certain fines and penalties and denying the deduction for punitive damages.

Contact: Kathy Kerrigan 4-7242

(4)

Kerry Amendment #2 to Small Business and Work Opportunity Act of 2007

Short Title: Repeal the AMT preference for section 1202

Description of Amendment: Section 1202 provides a partial exclusion for gain from certain small business stock. For alternative minimum tax purposes, section 57(a)(7) requires that seven percent of the amount excluded by section 1202 be added back into the AMT calculation. The amendment repeals this requirement. The amendment includes offsets sufficient to ensure that the amendment is revenue neutral.

Contact: Kathy Kerrigan 4-7242

Lincoln Amendment #1 to the Small Business and Work Opportunity Act of 2007

5

Short Title: An amendment to enable small businesses to provide health benefits for their employees

Description of Amendment: This amendment would allow small businesses to pool employees across state lines and provide tax incentives to inject competition into the small group insurance markets and encourage more small businesses to offer health insurance to their employees.

Offset: To be provided

Contact: Anna Taylor (4-1050)

6

Lincoln Amendment #2 to the Small Business and Work Opportunity Act of 2007

Short Title: An amendment to provide tax relief for Employee Stock Ownership Plans

Description of Amendment: This amendment would (1) exempt certain distributions, including dividends, by S corporations to an employee stock ownership plan (ESOP) from the penalty tax for premature employee benefit plan withdrawals; (2) exempt deductions for ESOP dividends from corporate alternative minimum tax adjustments based on adjusted earnings and profits; (3) allow deferral of the recognition of gain for certain sales to ESOPs sponsored by any domestic corporation, including S corporations; (4) allow reinvestment of ESOP stock proceeds eligible for nonrecognition of gain in certain mutual funds; (5) modify certain ESOP stock ownership rules; (6) allow early distributions from an ESOP for higher education expenses and first-time homebuyer purchases without penalty; and (7) allow a de minimis exception from pension plan diversification requirements for ESOP accounts with balances of $2,500 or less. This amendment is based on the Employee Stock Ownership Plan Promotion and Improvement Act (S. 1319, 109th).

Offset: To be provided

Contact: Anna Taylor (4-1050)

7

Lincoln Amendment #3 to the Small Business and Work Opportunity Act of 2007

Short Title: An amendment to provide timber tax relief

Description of Amendment: On behalf of the small family-owned timber businesses in our states, this amendment would allow a tax deduction (available to taxpayers whether or not they itemize deductions) for up to 60% of gains from certain sales or exchanges of timber. This amendment is based on the Timber Tax Act (S. 1791, 109th) and would help ensure parity in the code regarding timber gain.

Offset: To be provided

~~**Contact:** Anna Taylor (4-1050)~~

8

SCHUMER AMENDMENT #1 to the "Small Business and Work Opportunity Act of 2007"

Purpose of Amendment: To extend the Work Opportunity Tax Credit.

Background: The Chairman's Mark extends the Work Opportunity Tax Credit for five years, through December 31, 2012.

Amendment: The Schumer amendment would extend WOTC for one additional year, for a total of six years, through December 31, 2013. The cost of the amendment would be approximately $700 million in the ten-year window.

Offset: The amendment's cost would be offset by adding the provision that changed the foreign tax credit rules for large integrated oil companies that are dual capacity taxpayers, which passed the Senate in February 2006 as part of the "Tax Relief Act of 2006." The provision was scored as saving $776 million at that time.

Contact: Jeff Hamond, 4-4422.

(9)

SCHUMER AMENDMENT #2 to the "Small Business and Work Opportunity Act of 2007"

Purpose of Amendment: To extend the Work Opportunity Tax Credit.

Background: The Chairman's Mark extends the Work Opportunity Tax Credit for five years, through December 31, 2012.

Amendment: The Schumer amendment would extend WOTC for two additional years, for a total of seven years, through December 31, 2014. The cost of the amendment would be approximately $1.4 billion in the ten-year window.

Offset: Half of the amendment's cost would be offset by adding the provision that changed the foreign tax credit rules for large integrated oil companies that are dual capacity taxpayers, which passed the Senate in February 2006 as part of the "Tax Relief Act of 2006." The provision was scored as saving $776 million at that time. The rest of the offset will be provided at the appropriate time.

Contact: Jeff Hamond, 4-4422.

10

SCHUMER AMENDMENT #3 to the "Small Business and Work Opportunity Act of 2007"

Purpose of Amendment: To provide capital gains tax relief to certain widows and widowers.

Background: In 1997, Congress changed the law as it pertains to capital gains on home sales, allowing a $250,000 exclusion for individuals and $500,000 for couples if an ownership and use test have both been met. However, current law treats certain widows and widowers unfairly because someone can receive a significant tax penalty based on the month a spouse dies, and no other factor.

Amendment: The Schumer amendment is based on S. 138, a bill supported by Senators Kyl and Wyden. The amendment would give a widow or widower two years from the date of death to sell the home and still be eligible for the full exclusion, assuming the ownership and use tests have been met. (Current law requires that the home be sold in the calendar year of death, which is a hardship when someone dies late in the year.)

Offset: The cost should be relatively small, but an official revenue estimate has not been received. An offset will be provided at the appropriate time.

Contact: Jeff Hamond, 4-4422.

(11)

HATCH AMENDMENT #1
to
The Small Business and Work Opportunity Act of 2007
(cosponsored by Senators Lincoln and Smith)

Repeal excessive passive investment income as a termination event

Present Law

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. In addition, an S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income.

Reason for Change

The loss of the S corporation election is too severe a penalty for having excess passive income. The existence of a corporate level "sting" tax, at the highest corporate tax rate, is incentive enough to encourage S corporations to not purposefully receive excess passive income. In its 2001 recommendations for tax simplification, the staff of the Joint Committee on Taxation recommended that this rule be repealed.

Description of Amendment

The amendment would repeal the rule that an S corporation would lose its S corporation status if it has excess passive income for three consecutive years. The "sting" tax would continue to apply.

Revenue Effect

Unknown, but requested.

Offset

To be provided.

Evan Liddiard, 4-0619

12

HATCH AMENDMENT #2

to

The Small Business and Work Opportunity Act of 2007

(cosponsored by Senators Lincoln and Smith)

Increase the threshold for taxing excess passive income from 25 percent to 60 percent

Present Law

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.

Reasons for Change

The current 25 percent threshold is too low. It tends to punish unwary and unsophisticated taxpayers, which are mostly small and family owned businesses. Taxpayers who are aware of the rule can easily avoid it through planning. In its 2001 recommendations for tax simplification, the staff of the Joint Committee on Taxation recommended that this threshold be raised to 60 percent.

Description of Amendment

The amendment would increase the threshold for taxing excess passive income from 25 percent to 60 percent.

Revenue Effect

Unknown, but requested.

Offset

To be provided.

Evan Liddiard, 4-0619

13

HATCH AMENDMENT #3

to

The Small Business and Work Opportunity Act of 2007

Add the provisions of S. 4030, the Real Estate Investment Trust Investment Diversification and Empowerment Act of 2006 (109th Congress)

Description of Amendment

The REIT Investment Diversification and Empowerment Act of 2006 (RIDEA) includes the following provisions to help modernize the tax rules governing Real Estate Investment Trusts to permit REITs to better meet the challenges of evolving market conditions and opportunities:

Title I: Foreign Currency and Other Qualified Activities

The Internal Revenue Service (IRS) has long recognized that U.S. REITs can and do invest outside the U.S., essentially recognizing that any income generated from REIT-permissible sources outside of the U.S. should not jeopardize the REIT's tax status. However, the treatment of foreign currency gains directly attributable to overseas real estate investment is not wholly clear, and its correct characterization is becoming increasingly important as U.S. REITs strengthen their positions in foreign markets.

As U.S. REITs continue to expand their overseas investments, the correct characterization of foreign currency gains and other types of non-specified income and assets has become even more important. To ensure that foreign currency gains do not harm a REIT's tax status, the IRS has provided a short-term solution by allowing certain REITs to establish a subsidiary REIT in each currency zone in which a REIT invests. However, the use of subsidiary REITs, each of which must satisfy the complex myriad of REIT rules or risk disqualification of the parent REIT, is a cumbersome and unmanageable solution in the long term. Accordingly, RIDEA would clarify existing law by characterizing foreign currency gains generated by a REIT outside the U.S. as "good" REIT income so long as the REIT focuses on commercial real estate, as measured by specific objective rules. Despite the IRS' authority to prescribe similar rules, the absence of such guidance necessitates legislative clarification to provide certainty to REIT management and their shareholders within a more administrable framework.

RIDEA also would delegate to the IRS the express authority to issue guidance with respect to whether any other item of income should satisfy the REIT gross income tests or should not be taken into account in calculating these tests. While the IRS often has been willing to grant such rulings to specific taxpayers, these rulings cannot be relied on by other taxpayers and in any event do not cover all circumstances.

Accordingly, RIDEA would: (1) characterize foreign currency gains attributable to a REIT's ownership and operation of overseas real estate assets as qualifying income under REIT gross income tests; (2) conform the current REIT hedging rule to also apply to foreign currency gains and to apply those rules for purposes of the both REIT gross income tests under current law; (3) specifically provide the Department of the Treasury with the authority to issue guidance on other items of income to either qualify under the REIT gross income tests or to provide that items of income are not taken into account in computing those tests; (4) treat foreign currency as a qualifying real estate asset; and (5) make conforming changes to other REIT provisions reflecting foreign currency gains.

Title II: Taxable REIT Subsidiaries

As originally introduced in 1999, the REIT Modernization Act (RMA) limited a REIT's ownership in taxable REIT subsidiaries (TRS) to 25 percent of a REIT's gross assets. However, the limit was reduced to 20 percent when Congress ultimately enacted the RMA as part of the Ticket to Work Incentives Improvement Act of 1999.

RIDEA would increase the limit on TRS securities from 20 percent to 25 percent of a REIT's gross assets. The rationale for a 25 percent limit on TRSs that was contained in the RMA remains the same today. The dividing line for testing a concentration on commercial real estate in the REIT rules has long been set at 25 percent, and even the mutual fund rule uses a 25 percent test. An IRS study shows increasing amounts of taxes paid by new TRSs, and common sense tells us that permitting increased activities in a double tax regime should increase revenues to the fisc compared to a single tax regime.

Title III: Dealer Sales

The Internal Revenue Code imposes a 100 percent excise tax on profits generated on sales of property in which a REIT is acting as a dealer rather than an investor. Because of the confiscatory nature of this 100 percent excise tax, the Code provides a "safe harbor" under which a REIT can be assured that the excise tax does not apply if it satisfies a number of requirements. RIDEA would make two changes to the dealer safe harbor.

One requirement under current law is that the REIT not either make seven sales in a taxable year or sell more than 10 percent of its portfolio each year. However, the

test as currently constructed penalizes many REITs that have owned their properties for a long period of time. This is because the test is geared to the property's "tax basis," an amount that diminishes over time due to tax depreciation, rather than "fair market value", an amount that generally increases over time. Second, the current test requires that a REIT hold a property for at least four years, three years longer than the general holding period required to distinguish between an "investor" and a "dealer" in property.

RIDEA would update this safe harbor to test "fair market" value instead of "tax basis" to allow REITs that have owned their properties for longer periods not be penalized and thereby prevented from prudently managing the timing and extent of asset dispositions. As part of the REIT Modernization Act of 1999, Congress adopted a provision that utilizes fair market value rules for purposes of calculating personal property rents associated with the rental of real property. Thus, there is an analogous precedent for a fair value approach.

The safe harbor also would be amended to replace the four-year holding period with a two-year holding period. The four-year requirement is not consistent with other Code provisions that define whether property is held for long term investments, such as the one-year holding period to determine long-term capital gains treatment, and the two-year holding period to distinguish whether the sale of a home is taxable because it is held for investment purposes.

Title IV: Health Care REITs

Generally, rental payments made from a subsidiary owned by a REIT to that REIT are not considered qualified rental income for REIT purposes under the "related party rules". However, as part of the REIT Modernization Act of 1999 (RMA), a lodging REIT is allowed to establish a taxable REIT subsidiary (TRS) that can lease lodging facilities from a REIT holding a controlling interest, with the payments to the REIT considered qualified income under the REIT rules. The RMA also created a rule under which a TRS is not allowed to operate or manage lodging or health care facilities.

At the time the RMA was considered, it was not clear that health care REITs would be interested in such treatment, so health care facilities do not qualify for the RMA exception to the related party rules. Today, many operators of health care assets such as assisted living facilities do not want to bear the financial risks of being a lessee of such facilities and would rather act purely as an independent operator of the facilities. Health care REITs now believe that the TRS restriction is interfering with their ability to manage their operations in the most efficient manner.

RIDEA would conform the treatment of health care facilities to that of lodging facilities by treating as qualifying income rental payments attributable to a health care facility made to a REIT from a taxable REIT subsidiary. Under this proposal, a TRS would still be required to use an independent contractor to manage or operate health

care facilities, but payments collected by a REIT from its TRS renting health care facilities would be qualified income under the REIT tests.

Title V: Foreign REITs

Since imitation is the sincerest form of flattery, Congress should be proud that about 20 countries have enacted legislation paralleling the U.S. REIT rules after observing the benefits brought to the United States as a result of a vibrant REIT market. The number of countries that have adopted REIT-like legislation this past decade has greatly accelerated, with Israel being the latest country to do so and legislation in the United Kingdom going into effect on January 1, 2007. Although the tax code treats stock in a U.S. REIT as a real estate asset, so that it is a qualified asset that generates qualifying income, current law does not afford the same treatment to the stock of non-U.S. REITs.

A U.S. REIT might want to invest in another country through a REIT organized in that country. A company could lose its status as a U.S. REIT if it owns more than 10 percent of the foreign REIT's securities, even though the foreign company looks and acts like a U.S. REIT. A REIT should not be discouraged from investing in an entity that engages in the same activities that a U.S. REIT is allowed to undertake if it invests directly in another country.

RIDEA would amend the REIT rules to provide that income from, and interests in, foreign-qualified REITs would be treated as qualifying REIT income and assets under the U.S. REIT rules provided that under the laws of another country: (1) at least 75 percent of the foreign company's assets must be invested in real estate assets; (2) the foreign REIT either receives a dividends paid deduction or is exempt from corporate level tax; and (3) the foreign REIT is required to distribute at least 85% of its taxable income to shareholders on an annual basis.

Revenue Effect

Unknown, but requested.

Offset

To be provided.

Evan Liddiard, 4-0619

(19)

HATCH AMENDMENT #4

To

The Small Business and Work Opportunity Act of 2007

Provide Tax Equity Through Credits Equal to Amount of Payroll Taxes Paid on HSA Eligible Premiums and Contributions

Present Law

Individuals who obtain health insurance through their employers do not pay payroll or income taxes on the value of the premiums. Similarly, individuals who make Health Savings Account (HSA) contributions through their employer pay no payroll or income taxes on the amount of their contributions.

Reason for Change

Individuals who purchase HSA-eligible health insurance and make HSA contributions outside of their employment arrangement are treated inequitably. Individuals who purchase a high-deductible health plan (HDHP) on their own pay premiums with after-tax dollars, and HSA contributions are deductible for income tax purposes only. Because an increase in the minimum wage may impact the availability of health insurance in small businesses, these tax inequities should be addressed.

Description of Amendment

The amendment would provide refundable income tax credits equivalent to the amount of payroll taxes paid on HSA compatible insurance premiums (equivalent to a payroll tax deduction for the amount of premiums) and to the amount of payroll taxes paid on HSA contributions (equivalent to a payroll tax deduction for the amount of contributions). No payroll taxes would be diverted from the Social Security and Medicare Trust Funds.

Revenue Effect

Unknown, but requested.

Offset

To be provided.

Brendan Dunn, 4-9489

15

HATCH AMENDMENT #5

to

The Small Business and Work Opportunity Act of 2007

Allow High-Deductible Health Plan Premiums to be paid with Health Savings Account funds

Present Law

High Deductible Health Plan (HDHP) premiums cannot be paid from a Health Savings Account (HSA). Employees must use after-tax dollars to pay their share of premiums for employer-sponsored coverage, unless their employer provides a cafeteria plan under Section 125 of the Internal Revenue Code.

Reason for Change

Individuals in employer-sponsored health plans are increasingly responsible for a growing share of the premiums for the insurance. Yet they must use after-tax dollars to pay their share of those premiums. With increasing costs from a higher minimum wage, many businesses are likely to raise the employer's contribution to employees' health insurance. This amendment will help employees deal with this higher cost.

Description of Amendment

The amendment would allow high deductible health plan premiums to be paid with pre-tax dollars from an HSA.

Revenue Effect

Unknown, but requested.

Offset

To be provided.

Brendan Dunn, 4-9489

16

Lott/Kyl Amendment #1 to Small Business and Work Opportunity Act of 2007

Short Title: Extension of section 179 increased expensing for small business through 12/31/2012.

Description of Amendment: 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. 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.

The amendment extends for three years the increased amount that a taxpayer may deduct and the other section 179 rules applicable in taxable years beginning before 2010. Thus, under the amendment, these present-law rules continue in effect for taxable years beginning after 2009 and before 2013.

Contact: King Mueller 224-6253

17

Lott/Kyl Amendment #2 to Small Business and Work Opportunity Act of 2007

Short Title: Extension of the 15-year straight-line cost recovery period for qualified leasehold and restaurant improvements

Description of Amendment: 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. The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years.

The Amendment extends the 15-year straight-line cost recovery period for qualified leasehold and restaurant improvements through 12/31/2012.

Contact: King Mueller 224-6253

18

Lott/Kyl Amendment #3 to Small Business and Work Opportunity Act of 2007

Short Title: Extension of the 15-year recovery period for new restaurant buildings

Description of Amendment: 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. The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years.

The amendment extends the new 15-year recovery period for new restaurant buildings through 12/31/2012

Contact: King Mueller 224-6253

19

Lott/Kyl Amendment #4 to Small Business and Work Opportunity Act of 2007

Short Title: Extension of the 15-year recovery period for retail improvements

Description of Amendment: 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. The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years.

The amendment provides a statutory 15-year recovery period for qualified retail improvement property placed in service before 2013.

Contact: King Mueller 224-6253

20

Snowe #1 to the Small Business and Work Opportunity Act of 2007

Short Title: Small Business Expensing

Description of Amendment: The amendment would increase the Section 179 expensing limit to $150,000 and the phase-out threshold to $600,000.

Offsets: To be provided

Contact Name and Phone Number: Tuck Shumack 4-0596

21

Snowe-Lincoln #2 to the Small Business and Work Opportunity Act of 2007

Short Title: Small Business Tax Flexibility Act

Description of Amendment: The amendment would allow small business start-ups with gross receipts up to $5 million with greater flexibility to choose the taxable year that makes the most sense for their business cycle. The provision mirrors S. 270.

Offsets: To be provided

Contact Name and Phone Number: Tuck Shumack 4-0596

22

Snowe Amendment #3 to the Small Business and Work Opportunity Act of 2007

Short Title: SIMPLE Cafeteria Plan

Description of Amendment: The amendment would offer SIMPLE Cafeteria Plans as provided in the SIMPLE Cafeteria Plan Act, S. 723, introduced in the 109th Congress.

Offsets: To be provided

Contact Name and Phone Number: Tuck Shumack 4-0596

(23)

Senator Kyl Amendment #1 to the Small Business and Work Opportunity Act of 2007

Short Title: An amendment to extend the three depreciation provisions and WOTC through 2010.

Description: The amendment extends the 15-year recovery period for new restaurant buildings through 2010; extends the 15-year recovery period for retail improvements through 2010; extends the 15-year recovery period for leasehold and restaurant renovations through 2010; extends the Work Opportunity Tax Credit through 2010. All other provisions of the chairman's mark would be unchanged by the amendment.

Contact: Lisa Wolski
4-4521

24

AMENDMENT TO THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

Thomas Amendment #1 to The Small Business and Work Opportunity Act of 2007.

Short Title: An amendment to improve the operation of SIMPLE IRAs and 401(k)s and make retirement plans more accessible to small businesses and their employees.

Senator Thomas moves to include provisions to:

- Allow direct rollover from a SIMPLE IRA to another IRA,
- Reduce the penalty on SIMPLE distributions from 25 percent to 10 percent, bringing it into line with other plans,
- Permit employers to make additional contributions (up to 10 percent) under the non-elective formula,
- Permit employers to increase SIMPLE IRA matching contributions, consistent with the SIMPLE 401(k) formula, and
- Permit a mid-year change from a SIMPLE IRA or SIMPLE 401(k) to another plan.

See the attached summary for additional detail.

Offset to be provided.

Contact Name and Phone Number: Kimberly Pinter 224-6441

Small Business SIMPLE Savings Proposals

INCLUDED IN SENATE VERSION OF PPA (Sec. 1009 and 1008 of Pension Security and Transparency Act):

SIMPLE Plan portability

(HR 1776, HR 1960, and HR 2831. Not included in final bill.)

- Allow direct rollover from a SIMPLE IRA to another IRA. Currently, this is not allowed. JCT Score $140 million over 10 years (JCX-15-06)

Elimination of higher penalty on SIMPLE distributions

(Included in HR 1776. Also included in Senate version of H.R. 2830 in 2006)

- Penalty on SIMPLE distributions is 25%. The proposal would reduce penalty to 10% to be consistent with other plans. (May need to look at the 2-year waiting period.) JCT Score $238 million over 10 years (JCX-15-06)

AS REPORTED BY WAYS AND MEANS IN 2003:

Additional non-elective employer contributions to SIMPLE plans

(Included in HR 1776, HR 1960)

- permits employers to make additional contributions (up to 10 percent) under the non-elective formula. JCT Score $1.319 billion over 10.

Matching contribution rules for SIMPLE IRAs conformed

(Included in HR 1776, HR 1960)

- permits an employer to increase SIMPLE IRA matching contributions, consistent with the SIMPLE 401(k)formula. Negligible JCT score.

INTRODUCED BY PORTMAN AND CARDIN (HR 1776):

Permit a mid-year change from a SIMPLE IRA or SIMPLE 401(k) to another plan

(Included in HR 1776)

(25)

AMENDMENT TO THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

Thomas Amendment #2 to The Small Business and Work Opportunity Act of 2007, for himself and Senator Kyl.

Short Title: An amendment to extend all temporary tax relief provisions in the bill through 2012.

As the WOTC provision is already slated to be extended through 2012, Senator Thomas moves to extend all other temporary tax relief provisions included in the bill through 2012 as well, for the purpose of consistency.

Offset to be provided.

Contact Name and Phone Number: Kimberly Pinter 224-6441

26

SMITH-SCHUMER AMENDMENT #1
THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

Smith-Schumer Amendment #1 to the Small Business and Work Opportunity Act of 2007, for himself and Mr. Schumer.

Short Title: Domestic Partner Health Benefits Equity Act for the Self-Employed

Description of Amendment: To improve the self-employed tax deduction to allow for tax-preferred health insurance coverage of these individuals, the amendment would modify the definition of dependent under Code Section 152 but only for purposes of the self-employed deduction under Code Section 162(1). To extend the self-employed deduction to coverage of domestic partners of the self-employed, the portion of the dependent definition covering members of the same household would be applied without reference to the requirements that the taxpayer provide more than half the dependent's support and that the dependent earn no more than $3,400.

Senators Smith and Schumer move to include this provision in the Small Business and Work Opportunity Act of 2007.

Offset: To be provided.

Contact: Kara Getz, 224-2444

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SMITH AMENDMENT #2
THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

Smith Amendment #2 to the Small Business and Work Opportunity Act of 2007, for himself and Mr. Kerry.

Short Title: Start-up Credit for New Small Business Retirement Plan Contributions

Description of Amendment: The amendment would provide small employers with a tax credit for contributions to a new qualified defined contribution or defined benefit plan. The credit would be available for the plan's first three years.

Senators Smith and Kerry move to include this provision in the Small Business and Work Opportunity Act of 2007.

Offset: To be provided.

Contact: Kara Getz, 224-2444

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SMITH AMENDMENT #3
THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

Smith Amendment #3 to the Small Business and Work Opportunity Act of 2007, for himself and Mr. Kerry.

Short Title: Equalization of Tax Treatment of Retirement Plan Contributions of the Self-Employed

Description of Amendment: Contributions to a qualified retirement plan on behalf of the self-employed generally are not excluded for purposes of determining employment taxes. The amendment would permit the self-employed to exclude contributions to a qualified retirement plan when determining employment tax liability.

Senators Smith and Kerry move to include this provision in the Small Business and Work Opportunity Act of 2007.

Offset: To be provided.

Contact: Kara Getz, 224-2444

30

SMITH AMENDMENT #5
THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

Smith Amendment #5 to the Small Business and Work Opportunity Act of 2007, for himself and Mr. Kerry.

Short Title: Amend Plan Document Compliance Rules for Small Business Retirement Plans

Description of Amendment: Today all qualified retirement plans, including small plans, generally must adopt new amendments required by statute by the employer's due date for filing its income tax return. The amendment would require the IRS to develop rules that would exempt small plans from complying with the interim amendment requirements under Rev. Proc. 2005-66.

Senators Smith and Kerry move to include this provision in the Small Business and Work Opportunity Act of 2007.

Offset: To be provided.

Contact: Kara Getz, 224-2444

Statement of Senator Chuck Grassley
Senate Committee on Finance Markup
Tax Incentives for Business in Response to a Minimum Wage Increase
January 17, 2007

Today's markup deals with tax incentives to assist workers and businesses burdened by the increased Federal minimum wage. Let me, first off, thank Chairman Baucus for recognizing the reality of the linkage between the burden of the minimum wage and its effects on employers and workers, especially small business. Republican members insisted on the importance of small business tax relief. I took that concern to Chairman Baucus and he recognized the legitimacy of it. He also recognized the practical political reality. That reality is a minimum wage hike would likely not pass the Senate without small business tax relief. So, to those on his side who have been critical of Chairman Baucus for being practical, I'd ask them how they would propose to get a minimum wage increase across the goal line. It's one thing to live in political or ideological fantasy land and it's quite another to make law.

This markup follows up the hearing of one week ago on that same subject. At the hearing, we found that all of the major incentives before us today will tend to benefit businesses that will be burdened by the minimum wage increase. Now, none of these provisions really has a partisan flavor. That goes for the depreciation items and the work opportunity tax credit (WOTC).

Despite that general non-partisan flavor, members on my side generally would prefer that the Chairman's mark tilt more toward the current depreciation benefits and less toward later WOTC benefits. I recognize and respect that sentiment and the policy basis behind it. However, Chairman Baucus had to deal with sentiment in the Democratic Caucus that would prefer a greater tilt toward WOTC. Many in the Democratic Caucus don't want any tax relief at all. I want to thank Chairman Baucus for consulting with all members on this side. Chairman Baucus moved the mark away from the position of the Democratic members and closer to the middle. Chairman Baucus struck a balance between the sentiments of Republicans and Democrats. So, I'm pleased Mr. Chairman, that the Finance Committee is again looking to the middle of the road. Tax incentives targeted to small businesses and other businesses impacted by a minimum wage increase have been linked to minimum wage legislation by Republicans for over a decade. Democrats have, at times, joined Republicans in supporting this linkage. Last week I quoted from two former chairmen of this committee in their opening remarks on the conference agreement on the last piece of legislation that raised the minimum wage. I want to quote them again.

Senator Roth, then the chairman of the committee, described taxes as the sand that grinds the gears of small business. So, he saw merit in small business tax relief. Senator Roth went on to say: "[We will] proceed to the legislation on the minimum wage and small business taxes. We're anxious to move ahead on the small business tax legislation."

Senator Moynihan said, "My distinguished chairman, as always, has so stated the facts. But there is a small semantic issue here. Some call this the small business relief act; others on this side call it the minimum wage bill. But we will not resolve that tonight, nor need we."

The bottom line is the Chairman's mark contains a well-known set of small business tax relief measures. I look forward to helping the Chairman move these proposals along in the committee and floor process.

SENATOR BUNNING
Opening Statement
Small Business and Work Opportunity Act of 2007
17 January 2007

Mr. Chairman,

I look forward to a discussion of the bill before us today. I am pleased that Chairman Baucus recognizes the importance of pairing a potential increase in the minimum wage with tax changes that will benefit those small businesses that will be negatively impacted by the wage increase.

In a closely divided Senate, such as we have today, it is imperative that the majority and minority parties work together. The very existence of this tax package is recognition of that fact and I am glad that the majority party was open to understanding its importance.

While I am happy that we are considering this package, it is not perfect. A number of important provisions such as important cash accounting and Subchapter S corporation changes are included. However, I do believe that other important provisions were not given proper attention in this bill.

While I am a strong supporter of the Work Opportunity Tax Credit, and have been for many years, I feel that this tax package is out of balance. As currently written, over 40% of the size of the package is attributable to this one item. It would have been wiser to have a bill before us that more strongly recognized the importance of the depreciation and the Section 179 expensing provisions. I have long supported these provisions; I feel that a longer extension of their terms would have been appropriate. I have cosponsored an amendment today that reflects that belief.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR ROCKEFELLER

FINANCE COMMITTEE MEETING
JANUARY 17, 2007

Mr. Chairman, I want to congratulate you on putting together a very reasonable package for the committee to consider today. I understand that you have had pressure from many different directions, and I think your mark represents a practical approach that will help businesses create jobs at the same time that we increase the minimum wage.

I would like to raise concerns about one provision that has been included in your mark, related to the treatment of professional employer organizations. I believe that the Chairman is genuinely trying to improve oversight of PEOs and to make reforms to tax enforcement. However, just in the past few days, I have heard from labor organizations that have expressed serious concerns with the potential expansion of PEOs.

I want the Senate to be very careful that we do not approve any changes that would diminish workers' rights or create confusion in the employer-employee relationship. I know that the Chairman wants to do what's right. And I think we may need to revisit this issue. I look forward to working with him as this package continues through the process to be sure that we do not introduce any unintended consequences.

Again, Mr. Chairman, thank you for your leadership. I look forward to working with you as this package is considered by the full Senate.