

Reform the U.S. International Tax System

DEFER DEDUCTION OF INTEREST EXPENSE RELATED TO DEFERRED INCOME

Current Law

Taxpayers generally may deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business. The Internal Revenue Code and the regulations thereunder contain detailed rules regarding allocation and apportionment of expenses for computing taxable income from sources within and without the United States. Under current rules, a U.S. person that incurs interest expense properly allocable and apportioned to foreign-source income may deduct those expenses even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. For example, a U.S. person that incurs debt to acquire stock of a foreign corporation is generally permitted to deduct currently the interest expense from the acquisition indebtedness even if no income is derived currently from such stock. Current law includes provisions that may require a U.S. person to recapture as U.S.-source income the amount by which foreign-source expenses exceed foreign-source income for a taxable year. However, if in a taxable year the U.S. person earns sufficient foreign-source income of the same statutory grouping in which the stock of the foreign corporation is classified, expenses, such as interest expense, properly allocated and apportioned to the stock of the foreign corporation may not be subject to recapture in a subsequent taxable year.

Reasons for Change

The ability to deduct expenses from overseas investments while deferring U.S. tax on the income from the investment may cause U.S. businesses to shift their investments and jobs overseas, harming our domestic economy.

Proposal

The proposal would defer the deduction of interest expense that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax. For purposes of the proposal, foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax, thus the proposal would not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign source income (for example, royalty income) would be similarly treated.

For purposes of the proposal, the amount of a taxpayer's interest expense that is properly allocated and apportioned to foreign-source income would generally be determined under current Treasury regulations. The Treasury Department, however, will revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income.

Deferred interest expense would be deductible in a subsequent tax year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax

during that subsequent tax year. Treasury regulations may modify the manner in which a taxpayer can deduct previously deferred interest expenses in certain cases.

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

FOREIGN TAX CREDIT REFORM: DETERMINE THE FOREIGN TAX CREDIT ON A POOLING BASIS

Current Law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. Under section 902, a domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the deemed paid foreign tax credit). The foreign tax credit is limited to an amount equal to the pre-credit U.S. tax on the taxpayer's foreign-source income. This foreign tax credit limitation is applied separately to foreign-source income in each of the separate categories described in section 904(d), i.e., the passive category and general category.

Reasons for Change

The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign-source income. The reduction to two foreign tax credit limitation categories, for passive category income and general category income under the American Jobs Creation Act of 2004, enhanced U.S. taxpayers' ability to reduce the residual U.S. tax on foreign-source income through "cross-crediting."

Proposal

Under the proposal, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis based on the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in section 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year. The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

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

FOREIGN TAX CREDIT REFORM: PREVENT SPLITTING OF FOREIGN INCOME AND FOREIGN TAXES

Current Law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. Under current law, the person considered to have paid the foreign tax is the person on whom foreign law imposes legal liability for such tax.

Reasons for Change

Current law permits inappropriate separation of creditable foreign taxes from the associated foreign income in certain cases such as those involving hybrid arrangements.

Proposal

In the case of foreign taxes with respect to which a taxpayer claims credit under section 901, the proposal would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. In general, the proposal would allow a credit for such foreign taxes when and to the extent the associated foreign income is subject to U.S. tax in the hands of the taxpayer claiming the credit. This proposal would apply in addition to the section 902 "pooling" proposal described in this document. The Secretary would be granted authority to issue any regulations necessary to carry out the purposes of the proposal.

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

TAX CURRENTLY EXCESS RETURNS ASSOCIATED WITH TRANSFERS OF INTANGIBLES OFFSHORE

Current Law

Section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." The regulations under Section 482 provide that the standard to be applied is that of unrelated persons dealing at arm's length. In the case of transfers of intangible assets, section 482 further provides that the income with respect to the transaction must be commensurate with the income attributable to the intangible assets transferred.

Reasons for Change

The potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, puts significant pressure on the enforcement and effective application of transfer pricing rules. There is evidence

indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base.

Proposal

Under the proposal, if a U.S. person transfers an intangible from the United States to a related controlled foreign corporation that is subject to a low foreign effective tax rate in circumstances that evidence excessive income shifting, then an amount equal to the excessive return would be treated as subpart F income in a separate foreign tax credit limitation basket.

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

LIMIT SHIFTING OF INCOME THROUGH INTANGIBLE PROPERTY TRANSFERS

Current Law

Section 482 permits the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." Section 482 also provides that in the case of any transfer of intangible assets, the income with respect to the transaction must be commensurate with the income attributable to the intangible assets transferred. Further, under section 367(d), if a U.S. person transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign corporation in certain nonrecognition transactions, the U.S. person is treated as selling the intangible property for a series of payments contingent on the productivity, use, or disposition of the property that are commensurate with the transferee's income from the property. The payments generally continue annually over the useful life of the property.

Reasons for Change

Controversy often arises concerning the value of intangible property transferred between related persons and the scope of the intangible property subject to sections 482 and 367(d). This lack of clarity may result in the inappropriate avoidance of U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign persons.

Proposal

To prevent inappropriate shifting of income outside the United States, the proposal would clarify the definition of intangible property for purposes of sections 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal also would clarify that where multiple intangible properties are transferred, the Commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the Commissioner may value intangible property taking into consideration the prices or profits that the controlled

taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

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

DISALLOW THE DEDUCTION FOR EXCESS NONTAXED REINSURANCE PREMIUMS PAID TO AFFILIATES

Current Law

Insurance companies are generally allowed a deduction for premiums paid for reinsurance. If the reinsurance transaction results in a transfer of reserves and reserve assets to the reinsurer, potential tax liability for earnings on those assets is generally shifted to the reinsurer as well. While insurance income of a controlled foreign corporation is generally subject to current U.S. taxation, insurance income of a foreign-owned foreign company that is not engaged in a trade or business in the United States is not subject to U.S. income tax. Reinsurance policies issued by foreign reinsurers with respect to U.S. risks are generally subject to an excise tax equal to one percent of the premiums paid, unless waived by treaty.

Reasons for Change

Reinsurance transactions with affiliates that are not subject to U.S. Federal income tax on insurance income can result in substantial U.S. tax advantages over similar transactions with entities that are subject to tax in the United States. The excise tax on reinsurance policies issued by foreign reinsurers is not always sufficient to offset this tax advantage. These tax advantages create incentives for foreign-owned domestic insurance companies to reinsure direct insurance of U.S. risks with foreign affiliates to an extent that would not occur between unrelated parties acting at arm's length. It is inappropriate to allow a deduction for reinsurance premiums paid under such circumstances.

Proposal

Under the proposal, a U.S. insurance company would be denied a deduction for certain reinsurance premiums paid to affiliated foreign reinsurance companies with respect to U.S. risks insured by the insurance company or its U.S. affiliates. The U.S. insurance company would not be allowed a deduction to the extent that (1) the foreign reinsurers (or their parent companies) are not subject to U.S. income tax with respect to premiums received and (2) the amount of reinsurance premiums (net of ceding commissions) paid to foreign reinsurers exceeds 50 percent of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business.

The proposal provides that a foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this provision may elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States.

The provision is effective for taxable years beginning after December 31, 2010.

LIMIT EARNINGS STRIPPING BY EXPATRIATED ENTITIES

Section 163(j) limits the deductibility of certain interest paid by a corporation to related persons. The limitation applies to a corporation that fails a debt-to-equity safe harbor (greater than 1.5 to 1) and that has net interest expense in excess of 50 percent of adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction). Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year. In addition, the corporation's excess limitation for a tax year (i.e., the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent tax years.

Section 7874 provides special rules for expatriated entities and the acquiring foreign corporations. The rules apply to certain defined transactions in which a U.S. parent company (the expatriated entity) is essentially replaced with a foreign parent (the surrogate foreign corporation). The tax treatment of an expatriated entity and a surrogate foreign corporation varies depending on the extent of continuity of shareholder ownership following the transaction. The surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code if shareholder ownership continuity is at least 80 percent (by vote or value). If shareholder ownership continuity is at least 60 percent, but less than 80 percent, the surrogate foreign corporation is treated as a foreign corporation but any applicable corporate-level income or gain required to be recognized by the expatriated entity generally cannot be offset by tax attributes. Section 7874 generally applies to transactions occurring on or after March 4, 2003.

Reasons for Change

Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. In its 2007 study of earnings stripping, the Treasury Department found strong evidence of the use of such techniques by expatriated entities. Consequently, amending the rules of section 163(j) for expatriated entities is necessary to prevent these inappropriate income-reduction opportunities.

Proposal

The proposal would revise section 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons. The current law debt-to-equity safe harbor would be eliminated. The 50 percent adjusted taxable income threshold for the limitation would be reduced to 25 percent. The carryforward for disallowed interest would be limited to ten years and the carryforward of excess limitation would be eliminated.

An expatriated entity would be defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989. This special rule would not apply, however, if the surrogate foreign corporation is treated as a domestic corporation under section 7874.

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

REPEAL 80/20 COMPANY RULES

Current Law

Dividends and interest paid by a domestic corporation are generally U.S.-source income to the recipient and are generally subject to gross basis withholding tax if paid to a foreign person. A limited exception to these general rules applies with respect to a domestic corporation (a so-called “80/20” company) if at least 80 percent of the corporation’s gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business. Look-through rules apply to determine the character of certain income of the 80/20 company for this purpose.

Reasons for Change

The 80/20 company provisions can be manipulated and should be repealed.

Proposal

The proposal would repeal the 80/20 company provisions under current law.

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

PREVENT THE AVOIDANCE OF DIVIDEND WITHHOLDING TAXES

Current Law

A withholding agent generally must withhold a tax of 30 percent from the gross amount of all U.S.-source fixed or determinable annual or periodical (FDAP) income, profits, or gains of a nonresident alien individual, foreign corporation, or foreign partnership. In general, dividends paid with respect to the stock of a domestic corporation are U.S.-source dividends. Thus, foreign investors holding stock in domestic corporations are generally subject to 30-percent tax on dividends paid with respect to that stock. This rate may be reduced where the dividends are paid to a resident of a jurisdiction with which the United States has entered into a tax treaty.

The source of income from a notional principal contract is generally determined based on the residence of the investor. As a result, substitute dividend payments made to a foreign investor with respect to an equity swap referencing U.S. equities are treated as foreign-source and are therefore not subject to U.S. withholding tax.

Reasons for Change

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

Proposal

Income earned by foreign persons with respect to equity swaps that reference U.S. equities would be treated as U.S.-source to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. An exception to this source rule would apply to swaps which are unlikely to reflect avoidance of U.S. gross-basis taxation. The proposal would (1) ensure that economically equivalent transactions are subject to similar tax treatment, and (2) prevent avoidance of dividend withholding taxes by reforming the existing rules applicable to substitute dividends in a securities loan or a sale-repurchase transaction, while minimizing instances of over-withholding. The Treasury Department would be given regulatory authority to provide additional exceptions to implement the purpose of these rules.

The proposal would be effective for payments made after December 31, 2010.

MODIFY THE TAX RULES FOR DUAL CAPACITY TAXPAYERS

Current Law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under United States tax principles, regardless of the label attached to the levy under law. Under current Treasury regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive a specific economic benefit from the levying country (dual capacity taxpayers) may not credit the portion of the foreign levy paid for the specific economic benefit. The current Treasury regulations provide that, if a foreign country has a generally-imposed income tax, the dual capacity taxpayer may treat as a creditable tax the portion of the levy that

application of the generally imposed income tax would yield (provided that the levy otherwise constitutes an income tax or an in lieu of tax). The balance of the levy is treated as compensation for the specific economic benefit. If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable federal tax rate applied to net income is treated as a creditable tax. A foreign tax is treated as generally imposed even if it applies only to persons who are not residents or nationals of that country.

There is no separate section 904 foreign tax credit basket for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on foreign oil and gas income is limited in any year to the applicable U.S. tax on that income.

Reasons for Change

The purpose of the foreign tax credit is to mitigate double taxation of income by the United States and a foreign country. When a payment is made to a foreign country in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between a payment of creditable taxes and a payment in exchange for a specific economic benefit but fails to achieve the appropriate split between the two when a single payment is made in a case where, for example, a foreign country imposes a levy only on oil and gas income, or imposes a higher levy on oil and gas income as compared to other income.

Proposal

In the case of a dual capacity taxpayer, the proposal would allow the taxpayer to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual-capacity taxpayer. The proposal would replace the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax. The proposal also would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The proposal would yield to United States

treaty obligations to the extent that they allow a credit for taxes paid or accrued on certain oil or gas income.

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

Combat Under-Reporting of Income on Accounts and Entities in Offshore Jurisdictions

For too long, some Americans have evaded their taxpaying responsibilities by hiding unreported income in a foreign bank account, trust, or corporation. To reduce such evasion, the Administration is proposing a series of measures to strengthen the information reporting and withholding systems that support U.S. taxation of income earned or held through offshore accounts or entities.

REQUIRE INCREASED REPORTING ON CERTAIN FOREIGN ACCOUNTS

Current Law

A withholding agent generally must withhold tax at a rate of 30 percent from the gross amount of all U.S.-source fixed or determinable annual or periodical gains, profits, or income (FDAP income) of a nonresident alien individual or foreign entity. This 30-percent withholding tax may be reduced or eliminated pursuant to certain statutory provisions or pursuant to the terms of a tax treaty. A payor is generally required to withhold tax at a rate of 28 percent on a reportable payment made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number or fails to certify, when required, that the payee is not subject to backup withholding, or the payor is notified by the IRS or a broker that the payee is subject to backup withholding. To determine whether the recipient of a payment is exempt from withholding tax or eligible for a reduced rate, withholding agents generally must rely on beneficial ownership documentation provided by the payee certifying that the payee is entitled to an exemption from withholding tax or a reduced rate of withholding tax under a Code provision or relevant tax treaty. In general, withholding agents are entitled to rely on the self-certification they receive absent actual knowledge or reason to know that the information provided is incorrect or unreliable. In the case of payments made through an intermediary, the intermediary generally provides to the withholding agent the appropriate documentation on behalf of the payment's beneficial owners.

Treasury regulations specifically address certification, documentation, withholding, and reporting of payments to U.S. and foreign persons through foreign financial institutions (FFIs). FFIs may contract with the IRS to operate according to a set of withholding and reporting rules under the so-called "qualified intermediary" (QI) program. QIs agree to collect identifying documentation from their customers, file withholding tax returns and information returns, and submit to periodic audits performed by external auditors supervised by IRS examiners. QIs may furnish a withholding certificate to a withholding agent in lieu of transmitting to the withholding agent documentation for persons for whom the QI receives the payment and, in the case of U.S. non-exempt recipients, may assume primary Form 1099 reporting and backup withholding responsibility. If a QI assumes primary Form 1099 reporting and backup withholding responsibility with respect to accounts held by U.S. persons, such reporting may be limited to certain income earned through those accounts. Further, a QI that assumes primary Form 1099 reporting and backup withholding responsibility with respect to U.S. persons is not required to assume that responsibility for all accounts. Moreover, in the case of financial institutions that are part of a controlled group, one member of the controlled group may contract to be a QI while other members of the controlled group do not, and thus accounts and clients may be divided between commonly controlled QI and non-QI institutions.

Brokers are generally required to withhold tax at a rate of 28 percent on certain reportable payments made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number or fails to certify that the payee is not subject to backup withholding, or the payor is notified by the IRS or a broker that the payee is subject to backup withholding. Reportable payments include the gross proceeds from certain transactions effected by brokers for their customers. A broker is exempt from reporting a

payment (and thus backup withholding) where the broker can, prior to payment, associate the payment with documentation upon which it can rely to either treat the customer as a foreign beneficial owner, or treat the payment as made or presumed to be made to a foreign payee. With respect to payments through foreign intermediaries that are not qualified intermediaries (nonqualified intermediaries), brokers may rely on the beneficial owner's self-certification of non-U.S. status passed on by the nonqualified intermediary to determine whether certain third-party information reporting, and therefore backup withholding, may be required.

Reasons for Change

Strengthening the withholding and reporting rules under which FFIs operate with respect to U.S. persons will help to ensure that U.S. persons are properly paying tax on income earned through foreign accounts and that proper withholding tax applies with respect to foreign persons. In order to facilitate operation of this strengthened reporting and withholding program, a list of compliant FFIs must be made publicly available.

Proposal

Under the proposal, a withholding agent would withhold tax at a rate of 30 percent on payments to a FFI (including certain entities engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interests in the foregoing) of U.S.-source FDAP income and gross proceeds from the sale of any property of a type which can produce U.S.-source interest or dividends, unless the FFI has entered into an agreement with the IRS. The agreement would require the FFI to identify accounts (including debt and equity securities issued by the FFI that are not regularly traded on an established securities market) held at such FFI or at an FFI in the same expanded affiliated group by specified U.S. persons or by foreign entities in which a specified United States person owns, directly or indirectly, an interest of more than 10 percent (a United States owned foreign entity). The FFI would be required to report the name, address, and taxpayer identification number (TIN) of the U.S. account holder (or each substantial U.S. owner of the United States owned foreign entity account holder), the account balance or value, and the gross receipts and gross withdrawals or payments from the account. Instead of reporting the account balance and the gross receipts and gross withdrawals or payments from the account, a FFI may elect to report such information as such FFI would be required to report under sections 6041, 6042, 6045, and 6049 if such FFI were a United States

person and each holder of such accounts that is a specified United States person or a United States owned foreign entity were a natural person and citizen of the United States.

This proposal would not apply to a payment if the beneficial owner is a foreign government, an international organization, a foreign central bank, or any other class of persons that the Treasury Department concludes presents a low risk of tax evasion. The Treasury Department would be authorized to issue regulations to implement the purposes of this proposal. The rules would be designed so as not to disrupt ordinary and customary market transactions. Foreign beneficial owners of payments (other than

FFIs that do not qualify for the benefits of an income tax treaty with the United States) that are subject to withholding tax in excess of their income tax liability as a result of this proposal would be permitted to apply for a refund of any excess tax withheld.

The proposal would be effective beginning after December 31, 2012.

REQUIRE INCREASED REPORTING WITH RESPECT TO CERTAIN RECIPIENTS OF FDAP INCOME OR GROSS PROCEEDS

Current Law

In general, payments of U.S.-source fixed or determinable annual or periodical gains, profits, or income (FDAP income) to nonresident alien individuals and foreign entities are subject to withholding tax at a rate of 30 percent. This 30 percent withholding tax may be reduced or eliminated pursuant to certain statutory provisions or pursuant to the terms of a tax treaty.

To determine whether the recipient of a payment is exempt from withholding tax or eligible for a reduced rate, withholding agents generally must rely on beneficial ownership documentation provided by the payee certifying that the payee is entitled to an exemption from withholding tax or a reduced rate of withholding tax under a Code provision or relevant tax treaty. In general, withholding agents are entitled to rely on the self-certification they receive absent actual knowledge or reason to know that the information provided is incorrect or unreliable. In the case of payments made through an intermediary, the intermediary generally provides to the withholding agent the appropriate documentation on behalf of the payment's beneficial owners. Brokers are generally required to withhold tax at a rate of 28 percent on certain reportable payments made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number (TIN) or fails to certify that the payee is not subject to backup withholding, or the payor is notified by the IRS or a broker that the payee is subject to backup withholding. Reportable payments include the gross proceeds from certain transactions effected by brokers for their customers. A broker is exempt from reporting a payment (and thus backup withholding) where the broker can, prior to payment, associate the payment with documentation upon which it can rely to either treat the customer as a foreign beneficial owner, or treat the payment as made or presumed to be made to a foreign payee. With respect to payments through foreign intermediaries that are not qualified intermediaries (nonqualified intermediaries), brokers may rely on the beneficial owner's self-certification of non-U.S. status passed on by the nonqualified intermediary to determine whether certain third-party information reporting, and therefore backup withholding, may be required.

Reasons for Change

Persons that are not entitled to an exemption from withholding tax or a reduced rate of withholding tax may arrange to receive payments through entities (other than foreign financial institutions) that appear to qualify for an exemption or a reduced rate. A withholding agent making a payment to such an entity is unlikely to be in a position to determine whether the entity's self-certification regarding its qualification is accurate.

Proposal

Any withholding agent making a payment of U.S.-source FDAP income and gross proceeds from the sale of any property of a type which can produce U.S.-source interest or dividends to a foreign entity (other than a foreign financial institution) would be required to withhold a tax of 30 percent, unless the foreign entity certifies that no U.S. person owns, directly or indirectly, an interest of more than 10 percent or the foreign entity provides the name, address, and TIN of each such substantial U.S. owner, and the withholding agent does not know or have reason to know that any information provided is incorrect. Exceptions would be provided for payments to publicly traded companies and their subsidiaries, foreign governments, international organizations, foreign central banks, any entity that is organized under the laws of a possession of the United States and that is wholly owned by one or more bona fide residents of such possession, and other classes of person identified by the Secretary, or any class of payment identified by the Secretary, as posing a low risk of tax evasion.

The proposal would be effective for payments made after December 31, 2012.

REPEAL CERTAIN FOREIGN EXCEPTIONS TO REGISTERED BOND REQUIREMENTS

Current Law

In general, a taxpayer may deduct all interest paid or accrued within the taxable year on indebtedness. For registration-required obligations, a deduction for interest is allowed only if the obligation is in registered form. Generally, an obligation is treated as issued in registered form if the issuer or its agent maintains a registration of the identity of the owner of the obligation and the obligation can be transferred only through this registration system.

In addition to the denial of an interest deduction, an excise tax is imposed on the issuer of any registration-required obligation that is not in registered form. The excise tax is equal to one percent of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) during the period beginning on the date of issuance of the obligation and ending on the date of maturity.

Moreover, any gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation is treated as ordinary income (rather than capital gain), unless the issuer of the obligation was subject to the excise tax described above. Finally, deductions for losses realized by beneficial owners of registration-required obligations that are not in registered form are disallowed.

A foreign targeted obligation is excluded from the definition of a registration-required obligation.

Payments of "portfolio interest" are generally exempt from U.S. withholding tax to a nonresident alien or foreign corporation from sources within the United States. Interest

on an obligation that is not in registered form may qualify as portfolio interest if the obligation meets the foreign targeting requirements of section 163(f) (2) (B). Under title 31 of the United States Code, every "registration-required obligation" of the U.S. government must be in registered form, unless it is foreign targeted.

Reasons for Change

Bonds that are not in registered form may allow persons seeking to evade U.S. taxes the ability to invest in such obligations anonymously. Eliminating the foreign-targeted exceptions to the registration requirements will help to ensure that the owners of such obligations are properly identified and that income from such obligations is properly reported.

Proposal

The proposal would repeal the foreign targeted obligation exception to the denial of a deduction for interest on bonds not in registered form. Thus, under the proposal, a deduction for interest would be disallowed with respect to any registration-required obligation not issued in registered form. Under the proposal, a dematerialized book entry system or other book entry system specified by the Secretary would be treated as a book entry system for purposes of determining whether an obligation is in registered form.

Further, under the proposal, the foreign targeted obligation exception would not be available with respect to the ordinary income treatment of any gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation. Similarly, the foreign targeted obligation exception would not be available with respect to the present law rule disallowing deductions for losses realized by a beneficial owner of a registration-required obligation that is not in registered form. The proposal would include a conforming change to title 31 of the United States Code that repeals the foreign targeted exception to the definition of a registration-required obligation.

Finally, under the proposal interest paid on bonds that are not issued in registered form would not be treated as portfolio interest. Under the proposal, interest would qualify as portfolio interest only if it is paid on an obligation that is issued in registered form and for which the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a United States person, unless the Secretary determines that such a statement is not necessary.

The provision would be effective for obligations issued after the date which is two years after the date of enactment.

REQUIRE DISCLOSURE OF FOREIGN FINANCIAL ASSETS TO BE FILED WITH TAX RETURN

Current Law

United States persons must file certain information reports with respect to certain interests in foreign entities. Upon the formation, acquisition or ongoing ownership of certain foreign corporations, certain U.S. persons must file an information return providing information about foreign corporations in which they hold an interest. Similarly, certain U.S. persons must file information returns with respect to certain interests in a controlled foreign partnership, with respect to certain foreign trusts, and with respect to foreign disregarded entities. In addition, a U.S. person that capitalizes a foreign entity generally must file an information return regarding the transaction.

Under current law, taxpayers generally must indicate on their income tax returns whether they had an interest in or signature or other authority over a financial account in a foreign country during the year to which the tax return relates. If a taxpayer has a foreign account, the tax return refers the taxpayer to the Report of Foreign Bank and Financial Accounts, Form TD F 90-22.1 (FBAR). The FBAR requires the taxpayer to disclose whether, at any time during the preceding year, that person had an interest in, or signature authority over, financial accounts, if the aggregate value of these accounts exceeds \$10,000. The FBAR further requires the person to disclose certain information regarding the foreign account, including the account number, financial institution, and maximum value during the year. The FBAR is not required to be filed until June 30 of the year following the calendar year to which it relates. The FBAR is filed with the Treasury Department generally and not directly with the IRS.

Reasons for Change

Disclosure of more detailed information regarding foreign financial assets on the income tax return would assist the IRS in identifying and investigating instances where taxpayers have used foreign financial assets to evade U.S. taxes.

Proposal

Any U.S. individual who holds an interest in a foreign financial account, an interest in a foreign entity or any financial instrument or contract held for investment and issued by a foreign person would be required to file an information return if the aggregate value of all such assets exceeds \$50,000. The information return would set forth the name and address of the financial institution that maintains such account or the issuer of the instrument, and the maximum value of the asset during the year. The disclosure would be included as part of the tax return for the taxpayer. Penalties for failing to report the foreign financial asset would be consistent with current penalties under current law for failing to disclose an interest in a foreign entity, such that a failure to report the required information would result in a penalty of \$10,000, unless the failure is shown to be due to reasonable cause and not willful neglect. The Secretary would be given regulatory authority to apply the proposal to certain domestic entities formed or availed of for purposes of holding foreign financial assets, and to coordinate the proposal with other information returns required under the Code.

A rebuttable evidentiary presumption would be applicable in a civil administrative or judicial proceeding providing that, if it is established that the individual had an interest in an undisclosed foreign financial asset, then the aggregate value of all foreign financial

assets in which a U.S. individual has an interest will be presumed to exceed \$50,000. The rebuttable evidentiary presumption would not apply in criminal proceedings. The tax return disclosure would not replace or mitigate the individual's obligation to separately file an FBAR with the Treasury Department as required under Title 31. The penalties imposed under Title 31 for failing to file an FBAR would continue to apply to a failure to file an FBAR as required under Title 31. Failure to disclose the foreign accounts with the income tax return would not be subject to the Title 31 penalties, although it could give rise to penalties and other consequences imposed under the Code, including extension of the statute of limitations.

The proposal would be effective for taxable years beginning after the date of enactment.

IMPOSE PENALTIES FOR UNDERPAYMENTS ATTRIBUTABLE TO UNDISCLOSED FOREIGN FINANCIAL ASSETS

Current Law

Current law imposes a 20-percent accuracy-related penalty on (i) a substantial understatement of income tax, (ii) an understatement resulting from negligence or disregard of rules or regulations, and (iii) an understatement related to a reportable transaction. The 20-percent accuracy-related penalty increases to 30 percent in the case of an understatement from a reportable transaction that was not properly disclosed. The accuracy-related penalty is not imposed when the taxpayer demonstrates "reasonable cause" for the position and acted in good faith. In the case of a reportable transaction, the reasonable cause exception to the imposition of penalties only applies if the taxpayer disclosed the reportable transaction as required by law and certain other requirements are met.

Individual taxpayers must indicate on their income tax returns whether they had an interest in or signature or other authority over a financial account in a foreign country during the year to which the tax return relates. If the taxpayer had a foreign financial account, the income tax return instructs the taxpayer to refer to the Report of Foreign Bank and Financial Accounts (FBAR), which requires the taxpayer to disclose information regarding certain foreign accounts.

Under present law, failure to comply with the various information reporting requirements generally does not, in itself, determine the amount of the penalty imposed on an underpayment of tax.

Reasons for Change

United States persons may seek to evade U.S. tax liability by holding foreign financial assets. Increasing the penalties on understatements from transactions that involve undisclosed foreign financial assets would encourage proper disclosure of such accounts and deter the use of foreign financial assets to evade U.S. tax liability.

Proposal

In addition to the circumstances identified under current law, the 20-percent accuracy-related penalty would apply to any understatement attributable to undisclosed foreign financial assets. In addition, the proposal would double the 20-percent accuracy-related penalty to 40 percent in the case of such foreign financial asset understatements. Undisclosed foreign financial assets would be foreign financial assets that the taxpayer failed to disclose properly under section 6038, 6038B, 6046A, 6048, or the proposed requirement that taxpayers disclose foreign financial assets. As under current law, the penalty would not be imposed when the understatement is due to reasonable cause.

The proposal would be effective for taxable years beginning after the date of enactment.

EXTEND STATUTE OF LIMITATIONS FOR SIGNIFICANT OMISSION OF INCOME ATTRIBUTABLE TO FOREIGN FINANCIAL ASSETS

Current Law

In general, additional Federal tax liabilities in the form of tax, interest, penalties, and additions to tax must be assessed by the IRS within three years after the date a return is filed. If an assessment is not made within the required time period, the additional liabilities generally cannot be assessed or collected at any future time. Section 6501(c)(8) of the Code provides an exception to this general statute of limitations with respect to any tax relating to any event or period for which certain information returns are required with respect to certain foreign transfers, foreign entities, and foreign-owned entities. In these cases, the statute of limitations does not expire until three years after the taxpayer furnishes the information required to be reported.

Section 6038A of the Code requires certain foreign-owned domestic corporations to file information returns containing specified information with respect to related-party transactions, and to maintain such records as may be appropriate to determine the correct treatment of such transactions. Failure to file the required information returns triggers the section 6501(c) (8) extension of the statute of limitations.

A special rule is provided where there is a substantial omission of income. If a taxpayer omits substantial gross income on a return, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed. In the case of income taxes, a substantial omission means at least 25 percent of the amount that was properly includible in gross income; for estate and gift taxes, a substantial omission means 25 percent of a gross estate or total gifts.

Reasons for Change

Compliance with reporting and recordkeeping obligations is essential in order to enable the IRS to enforce the tax laws. The three-year period provided by section 6501(c) (8) does not always allow sufficient time for the IRS to determine a taxpayer's tax liability where the taxpayer has omitted income and failed to disclose foreign assets.

Proposal

Under the proposal, if the taxpayer omits from gross income more than \$5,000 that is attributable to one or more foreign financial assets required to be disclosed under the proposal to require disclosure of foreign financial assets (without regard to the \$50,000 threshold), the statute of limitation would be extended to six years after the required return was filed. In addition, the tolling of the statute of limitations under section 6501(c) (8) would apply to failures to file the reports that would be required under the proposal to require reporting of foreign financial assets.

The proposal would be effective for income tax returns due to be filed after the date of enactment, and returns filed on or before such date if the statute of limitations with respect to such return has not expired as of the date of enactment.

REQUIRE REPORTING OF CERTAIN TRANSFERS OF ASSETS TO OR FROM FOREIGN FINANCIAL ACCOUNTS

Current Law

United States persons must disclose whether, at any time during the preceding year, they had an interest in, or signature or other authority over, financial accounts in a foreign country, if the aggregate value of these accounts exceeds \$10,000. United States persons must also report certain information with respect to certain foreign business entities that they control. Under Treasury regulations, a U.S. person controls a foreign corporation for this purpose if the person owns, actually or constructively, more than 50 percent of the corporation's stock, by vote or by value. Current law does not contain a provision that generally requires reporting of transfers of money or property to, or receipt of money or property from, a foreign bank, brokerage, or other financial account by U.S. individuals.

Reasons for Change

The Administration is concerned about the use of foreign accounts by U.S. citizens and residents to evade U.S. tax. To reduce such evasion, the Administration proposes to increase information reporting requirements with respect to transfers to and from certain foreign accounts.

Proposal

A U.S. individual would be required to report, on the individual's income tax return, any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual. Additionally, any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest would be required to report any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the entity. Such an entity would also be required to report the name, address, and taxpayer identification number of any U.S. individual who owns more than 25 percent of the ownership interest in the entity. This reporting requirement would not apply if the cumulative amount or value of transfers, and the cumulative amount or value of receipts that would otherwise be reportable for a given year were each less

than \$50,000. The Treasury Department would receive regulatory authority to require the reporting of additional information, including classifying transfers and receipts as for investment or for arm's-length payments in the ordinary course of business for services or tangible property, or such other categories as the Secretary may prescribe. Failure to report a covered transfer would result in the imposition of a penalty equal to the lesser of \$10,000 per reportable transfer or 10 percent of the cumulative amount or value of the unreported covered transfers. No penalty would be imposed for a failure to report due to reasonable cause. The Treasury Department would receive regulatory authority to issue rules to prevent abuse of the reporting exemptions and to provide exceptions to the reporting requirement.

The proposal would be effective for transfers made after December 31, 2012.

REQUIRE THIRD-PARTY INFORMATION REPORTING REGARDING THE TRANSFER OF ASSETS TO OR FROM FOREIGN FINANCIAL ACCOUNTS AND THE ESTABLISHMENT OF FOREIGN FINANCIAL ACCOUNTS

Current Law

United States persons must disclose whether, at any time during the preceding year, they had an interest in, or signature or other authority over, financial accounts in a foreign country, if the aggregate value of these accounts exceeds \$10,000. Current law does not generally require third-party information reporting to the IRS with regard to the transfer of money or property to, or receipt of money or property from, a foreign bank, brokerage, or other financial account on behalf of a U.S. person, or with regard to the establishment of a foreign bank, brokerage, or other financial account on behalf of a U.S. person.

Reasons for Change

The Administration is concerned that U.S. persons are failing to comply with the requirement to report certain foreign financial accounts. Establishing a third-party reporting requirement with respect to transfers to foreign financial accounts, receipts from such accounts, and the establishment of such accounts would lead to greater disclosure of foreign financial accounts, and consequently would discourage the evasion of U.S. taxation. These third-party reporting requirements complement taxpayer reporting requirements.

Proposal

Any U.S. financial institution that during the year transfers to, or receives from, a foreign bank, brokerage, or other financial account money or property with an aggregate value of more than \$50,000 on behalf of a U.S. individual, or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest, would be required to file an information return regarding such transfer or receipt (including, in the case of a transfer by an entity, the name, address, and taxpayer identification number (TIN) of any U.S. individual who owns more than 25 percent of the ownership interest in such entity). Any U.S. financial institution that opens a foreign bank, brokerage, or other financial account on behalf of a U.S. individual, or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of

the ownership interest, would be required to file an information return with the IRS regarding such account, including reporting any amounts of money or property transferred by the financial institution to, or received by it from, such account. In addition to filing an information return with the Internal Revenue Service, the U.S. financial institution would be required to send a copy of such return to the U.S. individual, or entity, as to which the return is made.

Reporting would not be required where the U.S. financial institution determined the entity making or receiving the transfer was: a publicly traded corporation, or a subsidiary thereof; an organization exempt from tax under section 501; an individual retirement plan; the United States or any wholly owned agency or instrumentality thereof; any State, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing; any bank (as defined in section 581); any real estate investment trust (as defined in section 856); any regulated investment company (as defined in section 851); any common trust fund (as defined in section 584(a)); any trust which is exempt from tax under section 664(c) or is described in section 4947(a)(1); or an entity engaged in an active trade or business (other than the business of investing or similar activities).

Failure to file a required information return or to provide a copy of such return to the U.S. individual would result in the imposition of a penalty of \$50 with respect to each such failure. In the case of a failure to file due to intentional disregard, the penalty would be the greater of \$100 or 5 percent of the amount of the items required to be reported.

No penalty would be imposed for a failure to report due to reasonable cause.

The Treasury Department would receive regulatory authority to provide additional exceptions (including where the Secretary determines that the reporting would be duplicative of other reporting requirements), to limit the types of transfers subject to the reporting requirement, to require that certain additional information be reported, and to permit U.S. financial institutions to report additional transfers of money or property to, or from, a foreign bank, brokerage, or other financial account on behalf of a U.S. individual (or on behalf of an entity of which the U.S. individual owns, actually or constructively, more than 25 percent of the ownership interest).

The proposal would be effective for amounts transferred and accounts opened beginning after December 31, 2012.

PERMIT THE SECRETARY TO REQUIRE ELECTRONIC FILING BY FINANCIAL INSTITUTIONS OF CERTAIN WITHHOLDING TAX RETURNS

Current Law

Every withholding agent must file an annual return with the IRS on Form 1042, reporting all taxes withheld during the preceding year and remitting taxes still owing for such

preceding year. A withholding agent also must file an information return on Form 1042-S, providing all items of income specified in section 1441(b) paid during the previous year to foreign persons.

Reasons for Change

The Secretary's authority to require returns electronically is limited to persons required to file at least 250 returns during the year. Electronic filing reduces errors on the required returns and facilitates compliance and enforcement measures by the IRS.

Proposal

The proposal would permit the Treasury Department to issue regulations requiring electronic filing for any return filed by a financial institution with respect to any taxes withheld by the financial institution, regardless of the general 250 return threshold. The proposal would apply to returns the due date for which (determined without regard to extensions) is after the date of enactment.

ESTABLISH PRESUMPTION OF U.S. BENEFICIARY IN CASE OF TRANSFERS TO FOREIGN TRUSTS BY A U.S. PERSON

Current Law

A U.S. person that directly or indirectly transfers property to a foreign trust is generally treated as the owner of the portion of the trust attributable to that property for any year in which there is a U.S. beneficiary of any portion of the trust. A trust is treated as having a U.S. beneficiary for a taxable year unless under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, and if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.

Reasons for Change

In the absence of adequate information reporting, it is difficult for the IRS to determine whether a trust has a U.S. beneficiary. A presumption that a foreign trust receiving a transfer of property from a U.S. person has a U.S. beneficiary unless the transferor provides sufficient information with respect to the existence of U.S. beneficiaries will improve the ability of the IRS to enforce U.S. tax rules applicable to foreign trusts.

Proposal

Under the proposal, if a U.S. person directly or indirectly transfers property to a foreign trust (other than certain deferred compensation and charitable trusts), the trust would be presumed to have a U.S. beneficiary for purposes of the grantor trust rules unless the U.S. transferor files an information return with the IRS and demonstrates that (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of any U.S. person. The proposal

would also make certain clarifications of existing rules applicable to foreign trusts with U.S. grantors and beneficiaries.

This proposal would be effective for transfers of property made after the date of enactment.

TREAT CERTAIN UNCOMPENSATED USES OF FOREIGN TRUST PROPERTY AS A DISTRIBUTION TO U.S. GRANTOR OR BENEFICIARY

Current Law

In general, if a foreign trust makes a loan of cash or marketable securities directly or indirectly to any grantor or beneficiary of the trust who is a U.S. person, or to any U.S. person related to such grantor or beneficiary, the amount of the loan is treated as a distribution by the foreign trust to the grantor or beneficiary. In addition, the trust is not treated as a simple trust for the year of the distribution. The grantor trust rules do not currently treat a U.S. person receiving an uncompensated loan of cash or marketable securities, or the uncompensated use of trust property, as a U.S. beneficiary.

Reasons for Change

The administration is concerned that foreign trusts may permit the uncompensated use of trust property by U.S. persons without treating the value of the use as a trust distribution, and without treating the recipient as a U.S. beneficiary for purposes of the grantor trust rules.

Proposal

Under the proposal, if a foreign trust permits the use of trust property other than cash or marketable securities by a U.S. grantor or beneficiary (or a related U.S. person), the fair market value of the use of such property would be treated as a distribution to the U.S. grantor or beneficiary, except to the extent that the trust is paid the fair market value of such use within a reasonable period of time. In addition, for purposes of the grantor trust rules, a loan of cash or marketable securities or the use of other property of a foreign trust would be treated as paid or accumulated for the benefit of a U.S. person, except to the extent that the U.S. person repays the loan at market rates (or pays the fair market value of the use) within a reasonable period of time.

This proposal would be effective for loans made, and uses of property, after the date of enactment.

IMPROVE FOREIGN TRUST REPORTING PENALTY

Current Law

Certain information must be reported to the IRS with respect to certain foreign trusts. A civil penalty applies to persons who fail to file a timely return as required or who file an incomplete or incorrect return. Generally, the penalty is equal to 35 percent of the “gross

reportable amount,” which is defined as the gross value of property involved in a reportable event such as a gratuitous transfer to the trust, the gross value of the portion of the trust’s assets at the close of the year that is treated as owned by a United States person, or the gross amount of distributions received from the trust. In the case of a failure to report that continues for more than 90 days after the IRS mails notice of such failure, the penalty (in addition to the 35 percent penalty) is \$10,000 for each 30-day period (or fraction thereof) during which the failure continues. The total penalty with respect to any failure may not exceed the gross reportable amount.

Reasons for Change

In many instances, the IRS obtains information relating to the creation of a foreign trust from third parties, or the IRS discovers funding of a foreign trust from public records. Without the cooperation of persons actually involved with the trust, however, it is often difficult for the IRS to determine the gross reportable amount. If the IRS cannot determine the gross reportable amount, the IRS may not be able to assess the penalties, including the \$10,000 penalty for continued failure to report. The current penalty regime therefore may create an incentive for persons subject to the reporting requirement not to report or cooperate with the IRS in the hope that the IRS will not be able to determine the gross reportable amount, which is essential to presenting a prima facie case sufficient to meet the Code section 7491(c) burden of production to support the penalty.

Proposal

The penalty provision would be amended to impose an initial penalty of the greater of \$10,000 or 35 percent of the gross reportable amount (if the gross reportable amount is known). The additional \$10,000 penalty for continued failure to report would remain unchanged. Thus, even if the gross reportable amount is not known, the IRS may impose a \$10,000 penalty on a person who fails to report timely or correctly as required, and may impose a \$10,000 penalty for each 30-day period (or fraction thereof) that the failure to report continues. If the person subsequently provides enough information for the IRS to determine the gross reportable amount, the total penalties would be capped at that amount and any excess penalty already paid would be refunded. Accordingly, a person can stop the compounding of penalties by cooperating with the IRS so that it can determine the gross reportable amount.

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

Reform Treatment of Insurance Companies and Products

MODIFY RULES THAT APPLY TO SALES OF LIFE INSURANCE CONTRACTS

Current Law

The seller of a life insurance contract generally must report as taxable income the difference between the amount received from the buyer and the adjusted basis in the

contract, unless the buyer is a viatical settlement provider and the insured person is terminally or chronically ill.

Under a transfer-for-value rule, the buyer of a previously-issued life insurance contract who subsequently receives a death benefit generally is subject to tax on the difference between the death benefit received and the sum of the amount paid for the contract and premiums subsequently paid by the buyer. This rule does not apply if the buyer's basis is determined in whole or in part by reference to the seller's basis, nor does the rule apply if the buyer is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. Persons engaged in a trade or business that make payments of premiums, compensations, remunerations, other fixed or determinable gains, profits and income, or certain other types of payments in the course of that trade or business to another person generally are required to report such payments of \$600 or more to the IRS. However, reporting may not be required in some circumstances involving the purchase of a life insurance contract.

Reasons for Change

Recent years have seen a significant increase in the number and size of life settlement transactions, wherein individuals sell previously-issued life insurance contracts to investors. Compliance is sometimes hampered by a lack of information reporting. In addition, the current law exceptions to the transfer-for-value rule may give investors the ability to structure a transaction to avoid paying tax on the profit when the insured person dies.

Proposal

The proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

The proposal also would modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The proposal would apply to sales or assignment of interests in life insurance policies and payments of death benefits for taxable years beginning after December 31, 2010.

MODIFY DIVIDENDS-RECEIVED DEDUCTION FOR LIFE INSURANCE COMPANY SEPARATE ACCOUNTS

Current Law

Corporate taxpayers may generally qualify for a dividends-received deduction (DRD) with regard to dividends received from other domestic corporations, in order to prevent or limit taxable inclusion of the same income by more than one corporation. No DRD is allowed, however, in respect of any dividend on any share of stock (1) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property, or (2) that is held by the taxpayer for 45 days or less during the 91-day period beginning on the date that is 45 days before the share becomes ex-dividend with respect to the dividend. For this purpose, the taxpayer's holding period is reduced for any period in which the taxpayer has diminished its risk of loss by holding one or more positions with respect to substantially similar or related property.

In the case of a life insurance company, the DRD is permitted only with regard to the "company's share" of dividends received, reflecting the fact that some portion of the company's dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The regime for computing the company's share and policyholders' share of net investment income is sometimes referred to as proration.

A life insurance company's separate account assets, liabilities, and income are segregated from those of the company's general account in order to support variable life insurance and variable annuity contracts. A company's share and policyholders' share are computed for the company's general account and separately for each separate account.

The policyholders' share equals 100 percent less the company's share, whereas the latter is equal to the company's share of net investment income divided by net investment income. The company's share of net investment income is the excess, if any, of net investment income over certain amounts, including "required interest," that are set aside to satisfy obligations to policyholders. Required interest with regard to an account is calculated by multiplying a specified account earnings rate by the mean of the reserves with regard to the account for the taxable year.

Reasons for Change

The proration methodology currently used by some taxpayers may produce a company's share that greatly exceeds the company's economic interest in the net investment income earned by its separate account assets, generating controversy between life insurance companies and the IRS. The purposes of the proration regime would be better served, and life insurance companies would be treated more like other taxpayers with a diminished risk of loss in stock or an obligation to make related payments with respect to dividends, if the company's share bore a more direct relationship to the company's actual economic interest in the account.

Proposal

As under current law, required interest under the proposal would equal an earnings rate times the mean of reserves. For a separate account, the earnings rate would equal a gross earnings rate (net investment income of the account, divided by the mean of the account's assets), minus a company-retained percentage (amounts retained by the company from the account's net investment income, if any, divided by the mean of reserves). For this purpose, amounts retained by the company would be treated as funded proportionately by items included in net investment income and items not so included. Under the proposal, the company's share with regard to a separate account would approximate the ratio of the mean of the surplus attributable to the account to the mean of the account's assets. The company's share with regard to a company's general account would be computed as under current law.

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

EXPAND PRO RATA INTEREST EXPENSE DISALLOWANCE FOR CORPORATE-OWNED LIFE INSURANCE (COLI)

Current Law

In general, no Federal income tax is imposed on a policyholder with respect to the earnings credited under a life insurance or endowment contract, and Federal income tax generally is deferred with respect to earnings under an annuity contract (unless the annuity contract is owned by a person other than a natural person). In addition, amounts received under a life insurance contract by reason of the death of the insured generally are excluded from gross income of the recipient.

Interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts generally is not deductible, unless the insurance contract insures the life of a key person of the business. A key person includes a 20-percent owner of the business, as well as a limited number of the business' officers or employees. However, this interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment or annuity contract. In addition, the interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values based on a statutory formula. An exception to the pro rata interest disallowance applies with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. In the case of both life and non-life insurance companies, special proration rules similarly require adjustments to prevent or limit the funding of tax-deductible reserve increases with tax preferred income, including earnings credited under life insurance, endowment and annuity contracts that would be subject to the pro rata interest disallowance rule if owned by a non-insurance company.

Reasons for Change

Leveraged businesses can fund deductible interest expenses with tax-exempt or tax-deferred income credited under life insurance, endowment or annuity contracts insuring certain types of individuals. For example, these businesses frequently invest in investment-oriented insurance policies covering the lives of their employees, officers,

directors or owners. These entities generally do not take out policy loans or other indebtedness that is secured or otherwise traceable to the insurance contracts. Instead, they borrow from depositors or other lenders, or issue bonds. Similar tax arbitrage benefits result when insurance companies invest in certain insurance contracts that cover the lives of their employees, officers, directors or 20-percent shareholders and fund deductible reserves with tax-exempt or tax-deferred income.

Proposal

The proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers or directors, other than 20-percent owners of a business that is the owner or beneficiary of the contracts.

The proposal would apply to contracts issued after December 31, 2010, in taxable years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract would be treated as a new contract except that in the case of a master contract, the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

PERMIT PARTIAL ANNUITIZATION OF A NONQUALIFIED ANNUITY CONTRACT

Current Law

If a taxpayer receives an amount as an annuity under a nonqualified, deferred annuity contract, a proportionate part of the amount received is excluded from gross income because it is considered to represent a return of premiums or other consideration paid for the annuity. The proportionate part that is excluded from gross income is determined by an exclusion ratio, which equals the investment in the contract as of the annuity starting date divided by the expected return under the contract as of that date.

If, on the other hand, an amount is received under an annuity contract but not as an annuity, the amount either is included in gross income (if received on or after the annuity starting date) or is included in gross income to the extent allocable to income on the contract (if received before the annuity starting date).

The annuity starting date is the first day of the first period for which an amount is received as an annuity. This date is generally the later of the date on which the obligations under the contract became fixed, or the first day of the period that ends on the date of the first annuity payment.

Reasons for Change

Under current law, a taxpayer may exchange a portion of an existing annuity contract for a second annuity contract and, under certain circumstances, annuitize one of the contracts involved in the exchange. An exclusion ratio then applies to determine the extent to which amounts received as an annuity under the annuitized contracts are included in gross income. Current law does not, however, address the treatment of a transaction (sometimes known as a partial annuitization) in which the holder of an

annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis. It is appropriate that these transactions be treated consistently.

Moreover, the possibility that a partial annuitization could be taxed on an income-first basis rather than on a proportionate basis discourages some taxpayers from annuitizing existing deferred annuity contracts at a time when annuity payments are needed to fund their retirement.

Proposal

An exclusion ratio would apply to each amount received as an annuity with regard to a portion of a nonqualified deferred annuity contract that is partially annuitized. This treatment would be available only if: (1) the taxpayer irrevocably elects to apply a portion of the contract to purchase a stream of annuity payments; (2) the stream of annuity payments is either for at least ten years or for the life of one or more individuals; and (3) the exclusion ratio is computed based on the expected return and investment in the contract with regard to the portion of the contract that is annuitized.

The proposal would be effective for partial annuitizations that are effected after December 31, 2010.