Tax Alert

FEDERAL

May 2009

Subject:
Obama Administration Outlines Proposals for Tax Reform

Details

On May 11, 2009, the Treasury Department released *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* ("Green Book"), which provides a description of the Obama Administration's budget proposals affecting revenues. These proposals are an outline of the Administration's policy initiatives, and will serve as the blueprint for future discussions with Congress. The legislative process may take significant time as the proposed changes affect a multitude of Internal Revenue Code provisions, and members of Congress may not support the precise proposals made by the Administration. Thus, whether these proposals are ultimately enacted into law, how they may be modified, and when they will be effective, cannot be known.

Set forth below is a summary of many of the proposed changes affecting domestic taxation, or general administrative provisions. A separate summary of the international provisions may be found at http://www.bdo.com./download.aspx?id=1072. A significant underlying premise of the Green Book is that most of the tax cuts enacted earlier this decade, which are scheduled to expire on December 31, 2010, will be extended, except as noted.

General Provisions

- **Extend Certain Expiring Provisions through Calendar Year 2010.** Certain expiring provisions, including the optional deduction for state and local sales taxes, the new markets tax credit, the modified recovery period for qualified leasehold improvements and qualified restaurant property, the exclusion from unrelated business income of certain payments to controlling exempt organizations, incentives for empowerment and community renewal zones, credits for biodiesel and renewable diesel fuels, and several trade agreements, would be extended through December 31, 2010 (currently, these rules are set to expire December 31, 2009).

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

Business Tax Provisions

- **Permanently Extend the Research and Experimentation (R&E) Tax Credit.** Under current law, the R&E tax credit expires December 31, 2009. The R&E tax credit is 20 percent of qualified research expenses above a base amount. The base amount is the product of the taxpayer's average gross receipts for the four preceding years and the ratio of its research expenses to gross receipts for the 1984-88 period. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year. Taxpayers can elect the alternative simplified research credit, which is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The proposal would make the R&E tax credit permanent.

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- **Expand Net Operating Loss (NOL) Carryback**. Under current law, for taxpayers other than certain eligible small businesses, an NOL may generally be carried back two years and carried forward twenty years to offset taxable income in such years. The *American Recovery and Reinvestment Act of 2009* allows certain eligible small businesses whose average annual gross receipts do not exceed $15,000,000 to elect to carry back NOLs arising in 2008 for three, four or five taxable years. The Administration proposes to work with Congress to make an expanded carryback provision available to more taxpayers, but does not make a specific proposal.

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

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

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

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- **Tax Carried (Profits) Interests as Ordinary Income.** The income and loss of a partnership retains its character and flows through to the partners, who include such items on their tax returns. A partner may receive a partnership interest in capital or future profits in exchange for the contribution of cash and/or property, or in exchange for services. Partnership interests received in exchange for services are frequently profits interests rather than interests in the capital of the partnership. Accordingly, if a partnership recognizes long-term capital gain, the partners, including partners who provide services, include their shares of such gain on their tax returns as long-term capital gain. If the partner is an individual, such gain would be taxed at the reduced rates for long-term capital gains. Gain recognized on the sale of a partnership interest is generally treated as capital gain. Under current law, income attributable to a profits interest of a general partner is generally subject to self-employment tax, except to the extent the partnership generates income that is excluded from self employment taxes, such as capital gains.

  The proposal would tax a partner's share of income from a "services partnership interest" (SPI) as ordinary income, regardless of the character of the income to the partnership. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains of individuals. In addition, the partner would be required to pay self-employment taxes on such income. Gain recognized on the sale of an SPI would generally be taxed as ordinary income. An SPI is a carried interest held by a person who provides services to the partnership. To the extent that the partner who holds an SPI contributes "invested capital" (money or other property) and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest, income attributable to the invested capital would not be recharacterized. Similarly, the portion of any gain recognized on the sale of an SPI that is attributable to the invested capital would be treated as capital gain. Under an anti-abuse rule, similar treatment would be required for a "disqualified interest" such as convertible or contingent debt, an option, or any similar instrument. The proposal would be effective for taxable years beginning after December 31, 2010.

- **Require Accrual of Income on Forward Sale of Corporate Stock.** A corporation generally does not recognize gain or loss on the issuance or repurchase of its own stock, including on a forward sale (a sale in the future for consideration to be paid in the future) of its own stock. While a corporation does not recognize gain or loss on the issuance of its own stock, it does recognize interest income upon the current sale of stock for deferred payment. The proposal would require a corporation that enters into a forward sale of its stock to treat a portion of the payment as interest. The proposal would be effective for forward contracts entered into after December 31, 2010.

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

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

- **Deny Deduction for Punitive Damages**. No deduction is allowed for a fine or similar penalty paid to a government for the violation of any law. If a taxpayer is convicted of a violation of the antitrust laws, or enters a plea of guilty or *nolo contendere* (no contest) to such a violation, no deduction is allowed for two-thirds of any amount paid or incurred on a judgment or in settlement of certain civil suits. If neither of these two provisions applies, a deduction is allowed for compensatory and punitive damages. The proposal would deny a deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, the damages paid by the insurer would be included in the gross income of the insured person. The insurer would be required to report such payments to the insured person and to the Service. The proposal would apply to damages paid or incurred after December 31, 2010.

- **Impose Tax on Certain Offshore Oil and Gas Production**. Under current law, no tax is imposed on the production of oil and gas on the Outer Continental Shelf. The proposal would impose an excise tax on certain oil and gas produced offshore in the future. The Administration will work with Congress to develop the details of this proposal.

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

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

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

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

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

- **Repeal Percentage Depletion**. The capital costs of oil and gas wells are recovered through deductions for depletion rather than through depreciation. In lieu of cost depletion, certain taxpayers may claim percentage depletion with respect to oil and gas properties. The percentage depletion is a statutory percentage, which ranges from 15 to 25 percent, of the gross income from the property. The proposal would repeal percentage depletion for oil and gas wells, effective for taxable years beginning after December 31, 2010.

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

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

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

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- **Modify the Dividends Received Deduction for Life Insurance Company Separate Accounts**. Corporate taxpayers are generally entitled to a dividends received deduction with respect to dividends from a domestic corporation. The deduction is available to a life insurance company only with respect to the company's share of the dividends. The Service and life insurance companies have disagreed over the computation of the company's share. The proposal would modify the formula used to determine the company's share of dividends received. The proposal would be effective for taxable years beginning after December 31, 2010.

Individual Tax Provisions

- **Tax Rates**. In 2001, the tax rates applicable to individuals were reduced through December 31, 2010. The top tax bracket was reduced from 39.6 percent to 35 percent, and the second highest tax bracket was reduced from 36 percent to 33 percent. The proposal would reinstate the 36 percent and 39.6 percent tax brackets, but would extend the other tax rates. The proposal specifies a formula, rather than a dollar amount, at which the 36-percent rate would first apply. Using 2009 standards, this rate would begin to apply to taxable income of approximately $231,000 and $191,000 for married taxpayers filing jointly and single taxpayers, respectively. The proposal would be effective January 1, 2011.

- **Reinstate the Limitation on Itemized Deductions**. Prior to 2001, certain otherwise allowable itemized deductions were reduced by three percent of the amount by which adjusted gross income (AGI) exceeded a statutory floor that was indexed annually for inflation, but not by more than 80 percent of the otherwise allowable deductions. As part of the 2001 tax legislation, this limitation on itemized deductions has been reduced in stages. For 2008 and 2009, itemized deductions were reduced by one percent of AGI over the threshold, but not by more than 26⅔ percent. For 2009, the threshold is AGI of $166,800. For 2010, the reduction was to be completely eliminated. However, beginning in 2011, the full itemized deduction reduction of three percent of adjusted gross income exceeding the floor is scheduled to be reinstated. The proposal would allow the reinstatement of the limitation to become effective in 2011. For 2011, the threshold would be adjusted for inflation starting with a value of $250,000 in 2009 for married taxpayers filing jointly ($125,000 if filing separately) and $200,000 in 2009 for single taxpayers.

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

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adjusted. For 2011, the AGI floors would be adjusted for inflation starting with a value of $250,000 in 2009 for married taxpayers filing jointly ($125,000 if filing separately) and $200,000 in 2009 for single taxpayers.

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

- **Impose a 20-Percent Maximum Rate on Dividends and Capital Gains**. Under current law, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. These rates apply for purposes of both the regular tax and the AMT. Qualified dividends generally are taxed at the same rate as capital gains. The zero- and 15-percent rates for dividends and capital gains are scheduled to sunset for taxable years beginning after December 31, 2010. The proposal would permanently extend the zero- and 15-percent rates, and would create a 20-percent rate on long-term capital gains and qualified dividends. The higher rate would apply at the same levels as the 36-percent rate for taxpayers generally (see above).

- **Permanently Extend the "Making Work Pay" Credit**. In 2009 and 2010, individual taxpayers are eligible for a refundable tax credit of 6.2 percent of earned income up to a maximum credit of $400 ($800 for joint filers). Thus, workers receive a credit on the first $6,450 of earned income ($12,900 for joint filers). The credit phases out at a rate of 2 percent for taxpayers with modified adjusted gross income in excess of $75,000 ($150,000 for joint filers). The proposal would make the credit permanent, would index the beginning of the phase-out range for inflation, and would reduce the phase-out rate to 1.6 percent. The proposal would be effective for taxable years beginning after December 31, 2010.

- **Permanently Extend the American Opportunity Tax Credit**. The credit equals 100 percent of the first $2,000 plus 25 percent of the next $2,000 of qualified tuition and related expenses (including textbooks), for a maximum credit of $2,500. Forty percent of the otherwise allowable credit is refundable (for a maximum refundable credit of $1,000). The credit is available for the first four years of postsecondary education, and phases out for taxpayers with adjusted gross income between $80,000 and $90,000 ($160,000 and $180,000 if married filing jointly). The proposal would make the credit permanent, and would index the $2,000 tuition and expense amounts, as well as the phase-out thresholds, for inflation. The proposal would be effective for taxable years beginning after December 31, 2010.

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

Estate and Gift Tax Provisions

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

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

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

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

Administrative Provisions

- **Require Information Reporting on Payments to Corporations**. Businesses are required to report payments of $600 or more made during the year, but generally no reporting is required with respect to payments made to corporations. These payments are generally reported on Form 1099. The proposal would extend the information reporting requirement to payments made to corporations (other than tax-exempt corporations), and would be effective for payments made after December 31, 2009.

- **Require a Certified Taxpayer Identification Number from Contractors.** Businesses making payments of $600 or more to a non-employee service provider (contractor) that is not a corporation are required to report the payment, as well as the name, address, and taxpayer identification number (TIN) to the Service. The identifying information is provided by the contractor, but not verified by the Service. The proposal would require the contractor to provide the business its certified TIN. The business would be required to verify the TIN with the Service, which would be authorized to disclose whether the TIN-name combination matches its records. If the contractor fails to provide an accurate certified TIN, the business would be required to withhold tax at a flat rate on the gross payments. The proposal would be effective for payments made after December 31, 2009.

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

- **Require E-Filing by Certain Large Organizations**. Corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, are required to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for taxable years ending on or after December 31, 2006. In addition, private foundations and charitable trusts that

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file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns. The proposal would require all corporations and partnerships required to file Schedule M-3 to file their tax returns electronically. Thus, in effect, the sole criterion for electronic filing will be the same $10 million asset threshold as is applied to the Schedule M-3 requirement. In the case of certain other large taxpayers not required to file Schedule M-3 (such as exempt organizations), the regulatory authority to require electronic filing would be expanded to allow reduction of the current threshold of filing 250 or more returns during a calendar year. The proposal would be effective for taxable years ending after December 31, 2009.

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

- **Require Information Reporting for Sales of Life Insurance Policies**. Generally, the seller of a life insurance contract has taxable income equal to the difference between the selling price of the contract and the basis in the contract. The proposal would require the purchaser of an interest in a life insurance contract with a death benefit of $1 million or more to report the purchase price, the buyer's and seller's taxpayer identification numbers, and the issuer and policy number to the Service, the insurance company, and the seller. The proposal would also modify the transfer-for-value rules in order to reduce the types of transactions that could ultimately give rise to tax-exempt insurance proceeds. The proposal would apply to sales or assignments in taxable years beginning after December 31, 2010.

- **Require Information Reporting for Private Separate Accounts of Life Insurance Companies**. Generally, the earnings on investments held through a separate account of a life insurance company are tax-free or tax-deferred. However, if the policyholder has sufficient control over the investments the policyholder rather than the insurance company is treated as the owner of the investments. The proposal would require life insurance companies to report to the Service and the policyholder the amount of accumulated untaxed income, the total contract value, and the portion of the value invested in one or more private separate accounts. A private separate account is defined as one where a policyholder owns policies whose cash surrender value is at least 10 percent of the value of the separate account. The proposal would be effective for taxable years beginning after December 31, 2010.