



# Washington Council Ernst & Young

## *Legislative Alert*

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## **BUSH ADMINISTRATION UNVEILS FY 2009 BUDGET PROPOSAL**

Earlier today (February 4, 2008), the Bush Administration unveiled its Fiscal Year 2009 budget proposal, projecting a federal budget deficit of \$407 billion for FY 2009 (2.7 percent of gross domestic product ("GDP")). The final FY 2008 deficit is also projected to be \$410 billion, up significantly from OMB's Mid-Session Review issued last fall, which had projected a 2007 budget deficit of \$205 billion. These large near-term increases in the budget deficit are primarily attributable to assumptions that the Administration and Congress will reach agreement on an economic stimulus package of \$145 billion and that a slower economy will reduce corporate tax receipts by \$25 billion in FY 2009 relative to FY 2008.

The President's budget once again proposes to make permanent provisions enacted in 2001 and 2003 that are now scheduled to sunset on December 31, 2010, including the current individual income tax rates, the 15 percent rate on capital gains and dividends, marriage penalty relief, repeal of the estate and gift tax, and increased expensing for small businesses. The ten-year cost of making these provisions permanent is estimated at \$2.18 trillion.

The Administration projects the Federal budget deficit will fall from \$407 billion in FY 2009 (2.7 percent of GDP) to a surplus of \$48 billion in 2012, assuming enactment of the President's budget proposals. After 2012, however, the long-term outlook is much more pessimistic. The budget notes that if receipts are held at the 40-year historical average of 18.3 percent of GDP, exploding growth in the nation's three largest entitlement programs—Medicare, Medicaid and Social Security—would result in unsustainable budget deficits exceeding 20 percent of GDP by 2080.

Critics note that the projection of a budget surplus by 2012 relies upon overly optimistic economic growth and revenue projections, while leaving out items with substantial costs. For example, the Administration's budget includes the cost of providing relief from the individual alternative minimum tax (AMT) only for 2008, in effect assuming in the baseline additional revenues in FY 2009-2012 that would result from a significant increase in the number of individual AMT taxpayers. The budget also does not include the cost of fighting the wars on terrorism in Afghanistan and Iraq beyond 2008.

Several tax proposals included in the FY 2008 budget have been dropped and several new proposals have been added, but the vast bulk of the revenue proposals in the Administration's FY 2009 budget were carried over from last year. The budget once again includes proposals first advanced last year to assist individuals in purchasing health insurance coverage and to encourage individuals to save for their own health care costs. These include a \$15,000 standard deduction for health insurance

coverage for families (\$7,500 in the case of individuals), that would replace the existing individual income exclusion for employer-provided health insurance and the self-employed premium deduction. These changes are once again proposed to take effect for years after 2008. The revenue estimate, however, has shifted from a loss of \$33 billion over 10 years in the FY 2008 budget, to a \$32.5 billion 10-year revenue gain in this year's budget.

Most of the tax incentives proposed in the FY 2009 budget are identical to those proposed in last year's budget. The Administration once again proposes to expand tax-free savings opportunities and consolidate employer-based savings accounts. Minor changes were made to the Administration's proposed package of tax incentives for charitable giving from last year's budget (i.e., two provisions from the FY 2008 budget (repeal of the \$150 million limitation on qualified 501(c)(3) bonds and repeal of certain restrictions on the use of 501(c)(3) bonds for residential rental property) were dropped.

The FY 2009 budget once again includes a number of provisions designed to expand information reporting requirements and improve tax compliance. Of particular note is the large increase in the Administration's revenue estimate for its proposal to require information reporting on merchant card payment transactions -- up from \$2 billion as originally proposed in the FY 2007 budget, to \$11 billion in the FY 2008 budget, to \$18 billion in the FY 2009 budget.

Similar to last year, the Administration proposes a permanent extension of the R&D tax credit at a projected 10-year cost of \$133 billion (versus the \$117 billion 10-year cost estimated in the FY 2008 budget). The budget also proposes temporary extensions of a number of tax provisions scheduled to expire on December 31, 2008, including the New Markets Tax Credit, the subpart F active financing exception, and the subpart F CFC look-through exception. However, the budget does not propose extending energy tax incentives enacted in the Energy Policy Act of 2005 that expired on 12/31/2007 or due to expire at the end of 2008.

## **PERMANENT EXTENSIONS OF CERTAIN 2001 AND 2003 TAX CUTS**

***Permanent Individual Tax Cuts; Temporary AMT Relief.*** The most significant tax proposal included in the FY 2009 budget plan would make permanent the individual tax cuts enacted in 2001 and 2003, at 10-year cost of \$2.19 trillion. Specifically, the budget proposes to eliminate the 2010 "sunset" dates for most of the provisions enacted in 2001. As noted above, the budget provides a one-year temporary extension of the individual AMT "hold harmless" provisions, at a cost of \$46.69 billion.

## **EXTENSIONS OF EXPIRING PROVISIONS**

***Permanent R&D Credit.*** The Fiscal 2008 budget plan, consistent with prior Bush budgets, proposes to make the temporary R&D tax credit provision (including the enhancements contained in the *Tax Relief and Health Care Act of 2006*) permanent. The Administration also stated its concern that "features" of the R&D tax credit may limit its effectiveness and pledged to "work closely with the Congress to develop and enact reforms to rationalize the R&E tax credit and improve its incentive effect." The estimated 10-year cost of making the credit permanent is \$133.06 billion.

***Homebuyer Credit for the District of Columbia.*** The budget proposes to extend for two years, through 2009, the \$5,000 credit for first-time homebuyers in the District of Columbia. The credit expired at the end of 2007. The two-year extension would cost \$39 million over 10 years.

**Gains from the Sale of Electric Transmission Property.** The special rule allowing the deferral of tax on the gain from the sale or disposition of electric transmission property would be extended for one year, allowing taxpayers to elect deferral with respect to sales or dispositions that occur before Jan. 1, 2009. The extension would raise \$30 million over 10 years.

**New Markets Tax Credit.** The New Markets Tax Credit, which encourages investments in low-income communities, would be extended for one year by authorizing a maximum of \$3.5 billion in equity investments for 2009. The extension would cost \$1.29 billion over 10 years.

**Active Financial Services Provision in Subpart F.** For the first time since 2002, the Administration has proposed an extension of the temporary active financing exception that recognizes that insurance, banking, financing and similar businesses are active businesses generating income that should not be treated as currently taxable “passive” income for purposes of the anti-deferral rules under subpart F. This exception is scheduled to expire for taxable years beginning after December 31, 2008, but as stated in Treasury’s explanation “extension of this expiring provision will allow U.S.-based financial and insurance groups to continue their active international operations without incurring subpart F income.” Treasury estimates the ten year cost of the extension at \$2.6 billion.

**Look-through Rules to Prevent the Current Taxation of Payments Between Related CFCs Under Subpart F.** For the first time, the Budget includes an extension, of the temporary provision, first enacted in 2006, that permits look-through treatment for any dividends, interest, rents and royalties received by a CFC from a related CFC, as long as the payments reflect active business income that would not be Subpart F income. Treasury estimates the ten year cost of the extension at \$578 million.

**Retirement Plan Distributions to Those Called to Active Duty.** The exception to the 10 percent early withdrawal tax on distributions to individuals called to active duty for at least 179 days would be extended to individuals called to active duty on or before December 31, 2009, with no associated revenue cost.

**Tax Return Disclosures.** Provisions requiring the disclosure of tax return information for administration of veterans programs and terrorist activity would be extended for one year under the budget proposal, with no revenue cost associated. The current disclosure authority related to terrorist activities expired at the end of 2007, while the Veterans Affairs disclosure provision expires September 30, 2008.

**Excise Tax on Coal.** The budget proposal would retain the excise tax on coal at the current rates until the date on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the general fund of the Treasury. After repayment of the Fund’s debt, the reduced rates of \$0.50 per ton for coal from underground mines and \$0.25 per ton for coal from surface mines would apply and the tax per ton of coal would be capped at 2 percent of the amount for which it is sold by the producer. The proposal would be effective for coal sales after December 31, 2009. The provision would raise \$1.39 billion over 10 years.

**Election to Include Combat Pay as Earned Income for the Earned Income Tax Credit (EITC).** The availability of the current election to treat combat pay as earned income for purposes of the EITC would be extended through 2009 under the budget proposal.

## **PROVISIONS TO ENCOURAGE SAVINGS**

**Consolidate Employer-Based Savings Accounts.** The budget once again proposes consolidating and simplifying the rules governing employer-provided defined contribution retirement plans. The proposal would consolidate 401(k), SIMPLE 401(k), Thrift, 403(b), Governmental 457(b) plans, as well as SIMPLE IRAs and SARSEPs, into Employer Retirement Savings Accounts (ERSAs). The proposal would be effective for years beginning after December 31, 2008.

ERSAs would follow the current law rules for 401(k) plans. Employees could defer up to \$15,500 in 2008 with employees aged 50 and older able to defer an additional \$5,000. The maximum total contributions, including employer contributions, would be \$46,000. Contributions could be pre-tax or after-tax. Distributions of after-tax contributions would not be included in income. ERSAs would be subject to a new nondiscrimination test. The average contribution of highly compensated employees could not exceed 200 percent of the average contribution of non-highly compensated employees. If the average contribution of non-highly compensated employees exceeds 6 percent, no non-discrimination testing would apply. The current law ACP and ADP tests would be repealed.

ERSA plan sponsors could choose to operate under a safe-harbor in order to satisfy non-discrimination testing. The safe harbor would require that all eligible non-highly compensated employees receive fully vested employer-paid contributions of at least 3 percent of compensation. If the employer contributions are matching contributions, the match must meet one of two qualifying formulas. The first formula would require a 50 percent employer match for the elective contributions of the employee up to 6 percent of the employee's compensation. The second would be any alternative formula such that the employer's matching contribution does not increase as the rate of an employee's elective contributions increases, and the aggregate amount of matching contributions is at least equal to the aggregate amount of matching contributions that would be made if matching contributions were made on the basis of the first formula.

The proposal also includes a special rule for small employers, under which employers with ten or fewer employees making at least \$5,000 during the prior year would be able to fund an ERSA by contributing to a custodial account, similar to a current law IRA, provided the employer's contributions satisfy the design-based safe harbor. Treasury estimates that the proposal will result in a revenue loss of \$1.5 billion over ten years.

**Expand Tax-Free Savings Opportunities.** The Administration has once again proposed consolidating the existing law Individual Retirement Accounts into a Retirement Savings Account (RSA). Individuals could contribute up to \$5,000 in an RSA – married couples could contribute up to \$10,000, subject to an earnings limitation. There would be no income limitation on eligibility to contribute to an RSA. Contributions would be nondeductible. Qualified distributions would be tax-free, and could be taken after age 58 or on death or disability. Any nonqualified distribution would be includible in income, to the extent it exceeded basis, and would be subject to a 10 percent penalty. Distributions would be deemed to come from basis first.

The proposal would also create Lifetime Savings Accounts, or LSAs. Individuals could contribute up to \$2,000 to their own LSA, and could make contributions of up to \$2,000 to the accounts of other individuals. Total contributions to all accounts for an individual could not exceed \$2,000. Contributions would be nondeductible, but earnings would be tax free and all distributions would be tax-free. Individuals could convert balances from Coverdell Education Savings Accounts and Section 529 Qualified Tuition Program to their LSAs, subject to certain limitations.

The existing Saver's credit would be available for contributions to an RSA, but not an LSA. Both LSAs and RSAs would be effective as of January 1, 2009.

According to the Treasury Department, the combined revenue impact of the two proposals would be to raise \$7.9 billion over five years and lose \$600 million over ten years.

**PBGC Premiums.** Another proposal would give a broad range of the Pension Benefit Guaranty Corporation (PBGC) Board the authority to address deficits the agency faces in meeting its obligations by making a broad range of changes in premiums paid by plans.

## **SMALL BUSINESS EXPENSING**

The budget proposal would increase the small business expensing amount to \$200,000 annually, at a cost of \$7.58 billion over 10 years.

## **HEALTH CARE TAX INCENTIVES**

**Standard Deduction for Health Insurance (SDHI).** The President proposes a standard deduction for health insurance (SDHI) of \$15,000 for family coverage and \$7,500 for single coverage for those with “qualified” health insurance coverage, whether purchased through an employer or directly in the individual insurance market. Qualified coverage must meet certain minimum coverage requirements. The SDHI would replace the existing individual tax exclusion for health benefits purchased through an employer, the self-employed premium deduction, and the medical itemized deduction for those not enrolled in Medicare. (The SDHI also replaces previous proposals by the Administration to provide an above-the-line deduction for individuals’ high deductible insurance premiums and to provide a refundable tax credit for low income individuals.) A family or an individual that spends less on health insurance than the full SDHI would still receive the full SDHI. Employers would be required to report the value of health insurance coverage to their employees on their annual Form W-2 and such amounts would be subject to withholding and employment taxes. Rules are proposed to exclude a pro rata portion of the SDHI during a transition period. Businesses would continue to be allowed to deduct employer-provided health insurance as a business expense.

The Administration believes that the new flat deduction would address the rising cost of health insurance by removing the tax bias for more expensive employer-based insurance while also providing an incentive for the uninsured to purchase insurance. The provision would raise \$32.53 billion over 10 years.

**Expansion of Health Savings Accounts (HSAs).** The President proposes to expand upon current HSAs and increase incentives for individuals to purchase HSA-eligible coverage. HSAs were established in 2003 and allow for savings on a tax-preferred basis to pay for certain medical expenses provided that the individual is covered by a high deductible health plan (HDHP). The President’s budget contains the following changes to HSAs:

1. Plans with 50 Percent Coinsurance Would Qualify as HDHPs. Health plans would be considered HSA-eligible if they meet all the existing requirements of an HDHP except that, in lieu of satisfying the minimum deductible requirement, they have at least a 50 percent or higher coinsurance requirement and a minimum out-of-pocket exposure that, under guidelines established by the Secretary, would result in the same (or lower) premium as coverage under an HDHP under the current requirements for the same family or individual.

2. For HSA Purposes, Include as Qualified Medical Expenses any Medical Expense Incurred on or after the First Day of HSA Eligibility in a Year. The existing rule that denies tax-free treatment for HSA

funds used to pay medical expenses incurred prior to the establishment of the HSA would be changed so that HSA funds could be used to pay medical expenses incurred on or after the first day of eligibility in a particular year, as long as the HSA is established no later than the date for filing the return for that taxable year. This will provide more time for newly eligible taxpayers to set up their HSAs.

3. Allow Larger Employer Contributions for the Chronically ill. Contributions to HSAs on behalf of employees who are chronically ill or employees who have spouses or dependents who are chronically ill would be excluded from the comparability rules to the extent the contributions exceed the comparable contributions for other employees.

4. Allow Family Coverage to Include Coverage where each Individual in the Family Can Receive Benefits once They Have Reached the Minimum Deductible for an Individual HDHP. Many types of family coverage provide for an overall deductible that meets the requirements for family HDHP coverage, but include embedded deductibles for each family member below the minimum family deductible. Under current law, this does not constitute an HDHP. Under the proposal, such coverage would constitute a family HDHP if each individual embedded deductible is at least the minimum deductible for individual HDHP coverage, and the overall deductible is at least the minimum deductible for family HDHP coverage.

5. If Both Spouses are Eligible Individuals, Allow Both Spouses to Contribute the Catch-up Contribution to a Single HSA Owned by One Spouse.

6. Allow Contributions to HSAs to Be Made by Individuals Covered by an FSA or HRA, But Offset the Maximum Allowable HSA Contribution by the Level of FSA or HRA Coverage. Currently, FSA or HRA participation generally disqualifies individuals from contributing to HSAs because of the first-dollar nature of FSAs and HRAs. This proposal would make it much easier for individuals who change from a non-HDHP to an HDHP when they have HRA or FSA coverage.

All of the HSA proposals would be effective for tax years beginning after December 31, 2008. Treasury estimates the provisions will cost \$11.51 billion over 10 years.

**Improve the Orphan Drug Tax Credit.** Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions; however, expenditures for these trials are eligible for the credit only after the Food and Drug Administration (FDA) designates the drug as a potential treatment for a rare disease. This results in deferring clinical testing on orphan drugs until the taxpayer receives FDA approval. The Administration proposes to allow taxpayers to claim the orphan drug credit for expenses incurred prior to FDA designation if designation occurs prior to the due date (including extensions) for filing the tax return for the year in which the FDA application was filed. The proposal would be effective for qualified expenses incurred after December 31, 2007, and is estimated to have no revenue effect.

## **INCENTIVES FOR CHARITABLE GIVING**

The FY 2009 budget contains a package of charitable giving incentives. Permanent extensions of a number of temporary provisions include (1) tax-free distributions from IRAs to qualified charitable recipients (\$3.32 billion/10 years); (2) the enhanced charitable deduction for contributions of food inventory (\$1.52 billion/10 years); (3) the enhanced deduction for corporate contributions of computer equipment for educational purposes (\$1.84 billion/10 years); (4) increased limits on contributions of partial interests in real property for conservation purposes (\$245 million/10 years); and (5) the basis

adjustment to stock of S corporations contributing appreciated property (\$354 million/10 years). The Administration also proposes reforming the excise tax on investment income of private foundations (\$1.58 billion/10 years).

## **EDUCATION TAX INCENTIVES**

The budget contains two education-related tax provisions. The first is a permanent extension of the current law above-the-line deduction for out-of-pocket classroom expenses. This provision is expected to cost \$1.93 billion over 10 years.

The second education-related incentive is to allow the saver's credit for contributions to qualified tuition programs (QTPs). Under current law, taxpayers may receive a nonrefundable credit (the saver's credit) on up to \$2,000 of their compensation contributed to an employer-sponsored qualified retirement plan or IRA. The credit would be effective for years beginning January 1, 2009, and is estimated to cost \$2.26 billion over 10 years.

## **HOUSING**

New this year, the budget proposal includes a provision that would allow State and local governments to use tax-exempt bonds to refinance existing loans to assist eligible subprime borrowers. Currently, only new loans are eligible for tax-exempt "qualified mortgage bond" financing. Treasury said State and local governments could provide greater amounts and more significant levels of lower-cost financing relief to subprime borrowers if tax-exempt qualified mortgage financing were available for refinancing mortgagors. The proposal would provide temporary authority to use tax-exempt qualified mortgage revenue bonds for subprime refinancings for three years, from 2008 through 2010. The annual private activity bond cap would be increased by \$15 billion for use in refinancing eligible subprime loans during those three years. The provision would cost \$2.69 billion over 10 years.

## **ENERGY AND ENVIRONMENT**

As in previous budgets, the Administration proposes to repeal two provisions from the Energy Policy Act of 2005 (EPA). The EPA assigned a statutory recovery period of 15 years to natural gas distribution pipelines placed in service before January 1, 2011. Under prior law, natural gas distribution lines were assigned a 20-year recovery period and a 35-year class life. Under the FY 2009 budget, this provision would be repealed effective for natural gas distribution lines placed in service after December 31, 2008—i.e., to return to the 20-year recovery period and 35-year class life for natural gas distributions lines in effect under prior law. This provision would raise \$580 million over 10 years.

The budget would also increase the amortization period for geological and geophysical expenses (G&G costs) incurred by independent producers from two years to five years, effective for G&G costs incurred after December 31, 2008. Last year, Congress enacted legislation to increase the G&G amortization period to five years for integrated oil and gas producers. This provision is estimated to raise \$353 million over 10 years.

The Administration's budget also contains two environmental tax incentives. Under present law, taxpayers may elect to expense certain environmental remediation expenses paid or incurred before January 1, 2008. The Administration proposes to permanently extend expensing of brownfields remediation costs. This provision has a 10-year cost of \$2.87 billion. The budget also proposes to remove qualified private activity bonds issued to finance water and sewage facilities from the annual

State volume cap limitation on private activity bonds. The volume cap would be removed for bonds issued after December 31, 2008. This provision is estimated to cost \$214 million over 10 years.

## **RESTRUCTURE 9/11 ASSISTANCE TO NEW YORK CITY**

Similar to the budget proposal issued the previous two years, Treasury proposes to sunset certain existing New York Liberty Zone tax benefits and to replace them with \$2 billion in tax credits for city and State transportation infrastructure expenditures over a ten-year window.

## **SIMPLIFY THE TAX LAWS FOR FAMILIES**

***Clarify Uniform Definition of a Child.*** The budget recommends clarifying the definition of a qualifying child for all child-related tax benefits, effective for tax years beginning after December 31, 2008. The provisions would raise an estimated \$2.9 billion over 10 years.

***Simplify EITC Eligibility Requirements.*** The Administration proposes to reduce the complex EITC eligibility rules relating to filing status, presence of children in complicated family situations, and work and immigrant status effective for tax years beginning after December 31, 2008. The provisions would lose \$37 million over 10 years.

***Reduce Refundable Child Tax Credit Computational Complexity.*** The budget recommends several changes to the child tax credit. First, it would eliminate the multiple computations required for taxpayers with more than three children by eliminating the alternative formula; second, it conforms the definition of earned income with that used for EITC purposes. Finally, it would require taxpayers to reside in the United States. The proposal would be effective for tax years beginning after December 31, 2008 and would raise \$3.56 billion over 10 years.

## **TAX COMPLIANCE**

The Administration's budget once again includes several proposals to improve tax compliance. These include:

***Information Reporting on Payments to Corporations.*** Businesses would be required to file an annual information return for payments aggregating \$600 or more in a calendar year to a corporation (other than tax-exempt organizations). The proposal is for payments made to corporations on or after January 1, 2009. It is estimated to raise \$8.23 billion over 10 years.

***Require Basis Reporting on Security Sales.*** Certain brokers (including brokerage houses, mutual funds, asset managers and fiduciaries) would be required to report information regarding adjusted basis in connection with the sale of certain publicly traded securities. Brokers also would be required to report acquisition or disposition dates for securities to determine short-term or long-term gain or loss for taxpayers. The IRS and Treasury Department would be granted regulatory authority to promulgate rules, including exceptions, to implement this mandate. The reporting provisions would apply to securities acquired after December 31, 2009 and would raise \$7.48 billion over 10 years.

***Require Information Reporting on Merchant Payment Card Reimbursements.*** A merchant payment card proposal would require the institution that makes the payment to the merchant for a card transaction to make an annual information report to the Internal Revenue Service (IRS). The proposal would grant regulatory authority to allow exceptions from the requirements where the benefit of improved compliance from information reporting is outweighed by the cost of compliance, and to

prevent double reporting of amounts potentially reported under other provisions. The provision applies to payments made on or after January 1, 2010 and is estimated to raise \$18.73 billion over 10 years, up from \$10.74 billion over 10 years in the FY 2008 budget, and an estimated \$225 million over 10 years in the FY 2007 budget.

**Require a Certified Taxpayer Identification Number from Contractors.** A contractor receiving payments of \$600 or more in a calendar year from a particular business would be required to furnish the business (on Form W-9) the contractor's certified TIN. A business would be required to verify the contractor's TIN with the IRS. If a contractor fails to furnish an accurate TIN, the business would be required to withhold a flat rate percentage, varying from 15 to 35 percent, of gross payments. The proposal would be effective for payments made to contractors on or after January 1, 2009, and is expected to raise \$661 million over 10 years.

**Require Increased Information Reporting for Certain Government Payments for Property and Services.** The IRS and Treasury Department would be authorized to promulgate regulations requiring information reporting on all non-wage payments by Federal, State and local governments to procure property and services. Certain categories of payments would likely be excluded, including e.g., payments of interest, payments for real property, payments to tax-exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract. The proposal would be effective for payments made on or after January 1, 2009, and would raise an estimated \$266 million over 10 years.

**Increase Information Return Penalties.** Under present law, there is a first-tier penalty of \$15 (not to exceed \$75,000 per calendar year) per return for correct returns that are filed after the prescribed filing date but before 30 days has passed. A second-tier penalty of \$30 is imposed for each return that is not filed within 30 days of the prescribed date but before August 1. The third-tier penalty of \$50 applies to each return not filed by August 1. Under the budget proposal, the first-tier penalty would be doubled to \$30 and the calendar year maximum increased to \$250,000; the second-tier penalty would be doubled to \$60 and the calendar year maximum increased to \$500,000; and the third-tier penalty doubled to \$100, with the calendar year maximum increased to \$1.5 million. Lower penalties would be imposed on small filers. The proposal would be effective for all information returns due January 1, 2009, or later, and would raise \$391 million over 10 years.

**Foreign Trust Reporting Penalty.** A new provision in this year's budget would amend the current foreign trust reporting penalty of 35 percent of the gross reportable amount of the property to provide that, for reports filed on or after January 1, 2009, the initial penalty is the greater of 35 percent of the gross reportable amount or \$10,000. The provision would raise \$3 million over 10 years.

**Require E-Filing by Certain Large Organizations.** All corporations and partnerships required to file Schedule M-3 (Net Income/Loss Reconciliation for Corporations with Total Assets of \$10 Million or More) would be required to file their income tax returns electronically. Taxpayers could request waivers of the requirement if they cannot meet it due to technology constraints, undue financial burden, or other criteria to be specified in regulations. The provision would be effective for tax years ending on or after December 31, 2008, and would have no revenue effect.

**Implement Standards Clarifying When Employee Leasing Companies Can Be Held Liable for Clients' Federal Employment Taxes.** Standards would be set forth for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes, and solely liable for such taxes if they meet specified requirements. The provision would be effective for

employment tax returns required to be filed with respect to wages paid on or after January 1, 2009, and would raise an estimated \$57 billion over 10 years.

***Expand IRS Access to Information in the National Directory of New Hires for Tax***

***Administration Purposes.*** The Office of Child Support Enforcement of the Department of Health and Human Services maintains the National Directory of New Hires (NDNH), a database that contains newly-hired employee data from Form W-4, used to help State child support enforcement. Under present law, the IRS can obtain data from the NDNH, but only for purposes of administering the earned income tax credit. Under the proposal, the Social Security Act would be amended to expand IRS access to NDNH data for general tax administration purposes, effective upon date of enactment. The proposal has no revenue effect.

***Permit Disclosure of Prison Tax Scams.*** The IRS would be authorized to disclose certain limited tax return information about tax violations by inmates so that prison officials can punish and deter such conduct through administrative sanctions. The proposal would authorize disclosures after December 31, 2008, and would raise an estimated \$3 million over 10 years.

***Make Repeated Willful Failure to File a Tax Return a Felony.*** Any person who willfully fails to file tax returns in any three years within any five consecutive year period, if the aggregated tax liability for such period is at least \$50,000, would be subject to a new aggravated failure to file criminal penalty. The proposal would classify such failure as a felony, punishable by imprisonment of up to five years and a fine of up to \$250,000 (\$500,000 in the case of a corporation). The proposal would be effective for returns required to be filed on or after January 1, 2008, and would raise \$7 million over 10 years.

***Tax Compliance with Local Jurisdictions.*** Another new provision in this year's budget would treat Indian tribal governments (ITGs) as States for purposes of information sharing to the extent necessary for ITG tax administration. The proposal would be effective for disclosures made after enactment, and would raise \$5 million over 10 years.

***State Tax Adjustment.*** Another new provision would create an additional exception to the general three-year statute of limitations for Federal tax liability resulting from adjustments to State or local tax liability. The statute of limitations would be extended the greater of: (1) one year from the date the taxpayer files an amended tax return with the IRS reflecting adjustments to the State or local tax return, or (2) two years from the date the IRS receives information from the State or local revenue agency under an information sharing agreement in place between the IRS and a State or local revenue agency. The statute of limitations would be extended only with respect to the increase in Federal tax attributable to the State or local tax adjustment. The proposal would be effective for returns required to be filed after December 31, 2008, and would raise \$47 million over 10 years.

***Investigator Disclosure Statute.*** The current taxpayer privacy law would be clarified to state that it does not prohibit Treasury and IRS officers and employees from identifying themselves, their affiliation, and the nature and subject of an investigation, when contacting third parties during a civil or criminal tax investigation. The proposal would be effective for disclosure made after enactment and would raise \$10 million over 10 years.

***Impose Penalty on Failure to Comply with Electronic Filing Requirements.*** Certain corporations and tax-exempt organizations are required to file their returns electronically. Generally, filing on paper instead of electronically is treated as a failure to file. Additions to tax are imposed for the failure to file tax returns reporting a liability. The Administration proposes to create a new penalty for failure to comply with a requirement of electronic format for a return that is required to be filed

electronically. The penalty amount would be \$25,000 for corporations or \$5,000 for tax-exempt organizations. The new penalty would be effective for returns required to be electronically filed on or after January 1, 2009. The provision would raise \$6 million over 10 years.

## **TAX ADMINISTRATION**

***Make Section 1203 of the IRS Restructuring and Reform Act of 1998 (RRA98) More Effective and Fair.*** Section 1203 of RRA98 requires the IRS Commissioner to terminate an employee for certain specifically enumerated violations committed by the employee in connection with the performance of his or her official duties. The Administration proposes to modify this section by removing a number of specific items from the list of violations, effective upon enactment. The provision has no revenue effect.

***Allow for the Termination of Installment Agreements for Failure to File Returns and for Failure to Make Deposits.*** The proposal would permit the IRS to terminate an installment agreement if the taxpayer fails to timely file tax returns or if a taxpayer fails to timely make required Federal tax deposits. The proposal would be effective for failures occurring on or after the date of enactment. It has no revenue effect.

***Eliminate the Monetary Threshold for Counsel Review of Offers in Compromise.*** The proposal would eliminate the requirement that the opinion of Chief Counsel be placed on file for any accepted offer in compromise involving unpaid taxes, penalties, and interest equal to or exceeding \$50,000. This proposal would require the Secretary to establish standards for determining when an opinion of Chief Counsel must be obtained. The proposal would be effective for offers in compromise submitted or pending on or after the date of enactment. This proposal has no revenue effect.

***IRS Authority to Fund Undercover Operations.*** The proposal would extend IRS' authority to use the proceeds received from undercover operations through 2012, with no corresponding revenue effect.

***Increase Transparency of Cost of Employer-Provided Health Coverage.*** Employers providing health coverage to employees and their families would be required to report on the Form W-2 provided to employees and the IRS the value of the health coverage provided to the employee. Employers would generally use the same value for all similarly situated employees receiving the same category of coverage. It is expected that the amount reported as the value of coverage would be determined using the same methodology as the applicable premium for purposes of Consolidated Omnibus Budget Reconciliation Act (COBRA) continuation coverage under Section 4980B. The proposal has no revenue effect.

***Conform Penalty Standards Between Preparers and Taxpayers.*** Iraq war supplemental appropriations legislation (H.R. 2206) approved in 2007 expanded preparer penalties to cover all types of returns, increased the standard of conduct to "more likely than not," and expanded the amount of the penalties.

Under the FY 2009 budget proposal, the standard applicable to preparers when taking a position not disclosed on a return would be the substantial authority standard. Because the determination as to whether a transaction has a significant purpose of tax avoidance or evasion is inherently subjective to the taxpayer, the preparer standard applicable to tax shelters would also be substantial authority. A preparer would be required to have a reasonable belief that the position would more likely than not be sustained on the merits when taking a position with respect to a transaction determined to have a

potential for tax avoidance or evasion to which Internal Revenue Code Section 6662A applies. The standard applicable to preparers for disclosed positions would remain at reasonable basis. No penalty would be asserted against a preparer if the preparer has reasonable cause and good faith. The proposal would be effective for returns prepared after January 1, 2008 and would cost \$17 million over 10 years.

**Repeal Recently Enacted UBTI Exclusion for Brownfield Properties.** The American Jobs Creation Act of 2004 created a special exclusion from unrelated business taxable income (UBTI) for gain or loss from the sale or exchange of certain brownfield properties by tax-exempt organizations. Citing the "considerable complexity" that this provision adds to the Internal Revenue Code, the Administration proposes to repeal the special exclusion for taxable years beginning after December 31, 2008. It is estimated to raise \$66 million over 10 years.

**Tighten Earnings Stripping rule for Inverted Companies.** Each of the President's budgets for FY 2005 through FY 2008 contained the same proposal to modify the earnings stripping rules generally. In its November 2007 report on "earnings stripping," however, Treasury concluded that "there is no evidence of earnings stripping outside the context of [inverted companies]." Consistent with that conclusion, the budget for FY 2009 contains a proposal to tighten the limitation on the deductibility of interest paid by "expatriated entities" to related persons. The current law 1.5 to 1 debt-to-equity safe harbor would be eliminated. The adjusted taxable income threshold for the limitation would be reduced from 50 percent to 25 percent of adjusted taxable income with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee ("guaranteed debt"). Interest on guaranteed debt generally would be subject to the current law 50 percent of adjusted taxable income threshold. The indefinite carryforward for disallowed interest under the adjusted taxable income limitation of current law would be limited to ten years, and the 3-year carryforward of excess limitation would be eliminated. Treasury estimates that the proposal would raise \$1.3 billion over ten years.

Retroactive effective date. Significantly, although the proposed effective date is "date of enactment," an expatriated entity would be defined by applying the rules applicable to inverted companies (Section 7874 and the regulations thereunder) as if they were applicable for taxable years beginning after the July 10, 1989 effective date of the earnings stripping rules.

**Repeal Telephone Excise Tax on Local Service.** The Administration proposes to repeal the 3 percent excise tax on local telephone service effective for telephone bills issued 90 days after enactment. The proposal would cost \$1.08 billion over 10 years.

**Airport and Airway Trust Fund Financing.** The various taxes that support the Airport and Airway Trust Fund expire on February 29, 2008. The budget would extend them for one year. After that, the FY 2009 budget proposes to have the Federal Aviation Administration collect user fees for air traffic control services related to commercial aviation. Aviation fuel taxes also would be adjusted. These provisions are projected to cost \$75.6 billion over 10 years.

## **UNEMPLOYMENT INSURANCE**

**Incentives for Recovery of State Unemployment Benefit Overpayments and Delinquent Employer Taxes.** Under present law, State recoveries of benefit overpayments must be redeposited, first to the State's own clearing account and then into its Federal unemployment insurance trust fund. The budget asserts that this mandatory redeposit rule prevents the States from redirecting these amounts to future recovery activity and from using private collection agencies. The budget proposes

several incentives for States to devote more resources to increasing overpayment recoveries, including, among others: (1) allowing States to redirect up to 5 percent of overpayment recoveries to additional enforcement activity; (2) requiring States to impose a penalty of at least 15 percent on recipients of fraudulent overpayments; and (3) requiring penalty revenues to be used exclusively for additional enforcement activity. The provisions would be effective as of the date of enactment and are projected to raise \$1.58 billion over 10 years.

**Extend Unemployment Insurance Surtax.** The Administration proposes to extend the 0.2 percent surtax through December 31, 2009. This provision is estimated to raise \$590 million over 10 years.

## **MEDICARE, MEDICAID, SCHIP AND FDA**

The president's 2009 budget proposes a series of steep cuts in Medicare and Medicaid that Senate Finance Chairman Max Baucus (D-MT) has already pronounced "dead on arrival." The budget surprised many observers, however, by calling for \$19.7 billion in new spending for the State Children's Health Insurance Program over five years. The SCHIP proposal appears to split the difference with a bill vetoed by the President twice last year, which would have provided an additional \$35 billion for SCHIP over five years.

**Medicare.** The budget's entitlement reforms are largely borne by the Medicare program, which is targeted for a five-year reduction of \$178 billion. The Administration's "Fiscal Outlook" document says that the budget's overall reforms to entitlement programs "result in savings of \$16 billion in 2009, \$208 billion over the five-year budget horizon and \$619 billion over the 10-year horizon.... The majority of entitlement savings, \$603 billion over the 10-year period, are derived from reforms to Medicare and Medicaid," along with increases in premiums paid to the PBGC, cuts in Social Services Block Grants, modifying the Disability Insurance program and eliminating the Perkins loan program.

The budget proposes to slow Medicare's growth from its current rate of 7.2 percent to 5 percent in 2009. These savings, much of which would come from a 0.4 percent cut in annual payments to health care providers, "are estimated to produce a total of \$178 billion in savings" over five years, the budget says. The budget calls for "payment reforms to providers such as physicians and hospitals" to encourage them to provide more efficient care, and Medicare's payment policies for "for certain medical items and services" would be "better aligned with appropriate costs."

The budget says its Medicare reductions are required by an automatic budget "sequester" included in the 2003 prescription drug law, which is triggered when more than 45 percent of Medicare's total spending is projected to be drawn from general revenue (as opposed to the Medicare trust fund, funded by payroll taxes) for two consecutive years.

**SCHIP.** The budget acknowledges that "the Administration and the Congress have not been able to find common ground on the best way to reauthorize SCHIP." The House and Senate last year passed a bipartisan SCHIP reauthorization that would have increased the program's funding by \$35 billion over five years, but the administration proposed \$5 billion for the same period and adhered to that figure as the president vetoed the SCHIP bills twice.

The new budget would increase SCHIP funding to the states by \$19.7 billion through 2013, however. It also includes outreach grants of \$50 million in 2009 and \$100 million in each of the following four years for states, localities and schools to reach eligible uninsured children. Total spending for SCHIP would increase to \$45.1 billion in 2013, by which time the administration estimates the program would cover 5.6 million low-income children.

The proposed SCHIP funding increase is paired with “policies that will increase the long-term sustainability of SCHIP.” The budget would help those who are now uninsured to obtain health insurance, the “Fiscal Outlook” document says, “but does not move those who now have private health insurance into government programs. The budget also clarifies SCHIP eligibility by clearly defining income.”

The budget’s SCHIP request prompted Senate Finance Chairman Baucus to issue a statement on February 4 accusing the White House of “lowballing Congress last year on the amount needed to take care of our kids.” Ranking member Charles Grassley (R-IA) sent a letter the same day, asking HHS Secretary Mike Leavitt to respond to six questions about how the administration arrived at the new SCHIP funding figure. Leavitt will testify about the budget’s Medicare, Medicaid and SCHIP proposals at the Finance Committee on Wednesday (February 6, 2008).

**Medicaid.** Under the 2009 budget, Medicaid is targeted for a savings of \$1.8 billion in fiscal 2009 and a total of \$17.4 billion over five years. The blueprint proposes to maintain Medicaid’s home equity limit, which excludes individuals from eligibility for Medicaid Long Term Care if their home is worth more than \$500,000. The budget also proposes to give states “more flexibility to tailor acute-care benefits in a manner that better meets the needs” of higher-income long-term care populations.

The budget proposes to allow states to require all Medicaid beneficiaries to be enrolled in managed care, and the Bush Administration also plans to issue a regulation detailing which managed-care services are allowable under section 1915(b)(3) of the Social Security Act, “to ensure that savings generated by managed care are spent appropriately and to remove ambiguity about how those savings can be used.”

The budget again proposes to remove “best price” from the Medicaid prescription drug rebate formula, “to allow manufacturers to negotiate deeper discounts in the private sector without affecting rebate levels.” Reimbursements for multiple-source prescription drugs would also be “rationalized,” and the budget calls for Medicare Part D and Medicaid to share data about drug claims, “which would allow states to better manage beneficiary care.”

**FDA and Biogenerics.** The budget includes a \$2.4 billion increase for the Food and Drug Administration, much of which is targeted for increased inspections of food, drugs and devices being shipped into the United States. Notably, the FDA budget for the first time includes language relating to a “regulatory pathway” for follow-on biologics, funded by user fees. “The budget proposes to establish a new regulatory pathway for FDA to approve follow-on biologics (FOB),” the Analytical Perspectives document says. “FOBs are generic versions of therapies that contain proteins derived from living cells. The administration proposal would protect patient safety, promote innovation, and include a financing structure to cover the costs of this activity through user fees,” though the budget does not estimate what the user fees will be.

At a briefing today, FDA officials reportedly said the agency will submit biogenerics legislation to Congress that will “include necessary provisions to ensure the safety and effectiveness of these biologic products for patients,” and will call for a “predictable and public guidance process for licensing follow-on protein products.” The proposal will also have “adequate intellectual property protections to preserve continued robust research into new and innovative life-saving medications,” according to FDA.

If you have questions, or need additional information, please feel free to contact anyone here at Washington Council Ernst & Young at (202) 293-7474.