

# Client Alert.

October 1, 2010

## Small Business Jobs Act of 2010 – Key Revenue-Raising Provisions

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As discussed in our prior client alert, President Obama signed into law the Small Business Jobs Act of 2010 (H.R. 5297, the “Act”) on September 27, 2010.<sup>1</sup> The Act includes \$12 billion in tax cuts aimed at small businesses, provides incentives to help small businesses grow, and expands lending to small businesses. To offset these tax cuts, the Act includes several revenue-raising provisions, as discussed in more detail below.

Key revenue-raising provisions in the Act include the following:

### SOURCE RULES FOR INCOME ON GUARANTEES

Subject to numerous exceptions, the U.S. generally imposes a 30% withholding tax on U.S.-source fixed or determinable, annual or periodical income (“FDAP”) of a nonresident alien individual or foreign corporation that is not effectively connected with the conduct of a U.S. trade or business.<sup>2</sup> Examples of FDAP include interest, dividends, rents, royalties, salaries, and annuities. While it has detailed rules to determine the source of various types of FDAP such as dividends and interest, the Code is silent with respect to other types of FDAP, such as guarantee income.

The source of guarantee income was at issue in *Container Corp. v. Commissioner*.<sup>3</sup> In *Container Corp.*, a Mexican corporation guaranteed certain of its U.S. subsidiary’s notes. In exchange for this guarantee, the U.S. subsidiary paid the Mexican parent corporation a guarantee fee equal to 1.5% of the outstanding principal balance of the notes. The U.S. subsidiary did not withhold any U.S. Federal income tax on the guarantee fees. The IRS asserted that the guarantee fees were U.S.-source FDAP because they were analogous to interest paid by the U.S. subsidiary. Interest income is sourced according to the place of residence of the obligor.<sup>4</sup> The U.S. subsidiary argued that the guarantee fees were more analogous to service income and should be treated as non-U.S.-source FDAP since the services provided by the Mexican parent were performed in Mexico.<sup>5</sup> In siding with the U.S. subsidiary, the Tax Court found that the Mexican parent’s creditworthiness, goodwill, and other assets produced the guarantee fees and that such fees were more analogous to

<sup>1</sup> Morrison & Foerster LLP Legal Update, Small Business Jobs Act of 2010 – Key Tax Incentive Provisions (Sept. 28, 2010) available at <http://www.mofo.com/files/Uploads/Images/100928-Jobs-Act.pdf>.

<sup>2</sup> Sections 871(a) and 881(a) of the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>3</sup> 134 T.C. No. 5 (Feb. 17, 2010).

<sup>4</sup> Code Sections 861(a)(1) and 862(a)(1).

<sup>5</sup> Payments for the performance of services are generally sourced according to the location where the services were performed. Code Sections 861(a)(3) and 862(a)(3).

# Client Alert.

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payments for the performance of services. The Tax Court then concluded that since the parent was located outside the U.S., and its services were performed outside the U.S., the guarantee fees were not U.S.-source and, therefore, were not subject to U.S. withholding tax.

The Act effectively overrides the Tax Court's holding in *Container Corp.* by amending the source rules to address income from guarantees issued after September 27, 2010. Under new Code Section 861(a)(9), U.S.-source income includes (i) amounts received (directly or indirectly) from a non-corporate resident or a domestic corporation for the provision of a guarantee of indebtedness of such person and (ii) amounts received from a foreign person (directly or indirectly) for the provision of a guarantee of indebtedness of that foreign person if the payments received are effectively connected with the U.S. trade or business of such foreign person. In addition, the Act provides that this new rule applies to payments that are made indirectly for the provision of a guarantee. The legislative history provides the following example of payments made indirectly for a guarantee: A foreign parent of a U.S. subsidiary guarantees the debt of such U.S. subsidiary owed to a foreign bank. However, instead of receiving a guarantee fee from its U.S. subsidiary, the foreign parent receives a fee from the foreign bank, which recoups this cost by charging additional interest to the U.S. subsidiary. In this case, new Code Section 861(a)(9) would treat the fees received by the foreign parent from the foreign bank as U.S.-source guarantee fees.

This provision in the Act is effective for guarantees issued after September 27, 2010. The Act's legislative history states that no inference is intended regarding the source of income received with respect to guarantees issued before September 27, 2010.

## INCREASE IN INFORMATION RETURN PENALTIES

*Code Section 6721.* Currently, Code Section 6721 imposes a penalty on any person who is required to file a correct information return and who fails to do so on or before the prescribed filing date. Code Section 6721's failure to file penalty varies depending on when the correct information is filed. If the correct information return is filed within 30 days after the prescribed filing date, the penalty is \$15 per return, with a maximum penalty of \$75,000 per calendar year ("first-tier penalty"). If the correct information return is filed more than 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is \$30 per return, with a maximum of \$150,000 per calendar year ("second-tier penalty"). If a correct information return is not filed on or before August 1 of any year, the penalty is \$50 per return, with a maximum of \$250,000 per calendar year ("third-tier penalty"). If the failure to file is due to intentional disregard of the filing requirement, the minimum penalty for each failure is \$100, with no maximum.

The maximum penalties under Code Section 6721 are reduced for small business (i.e., firms having average annual gross receipts for the three most recent taxable years of \$5,000,000 or less). For small business, the maximum first-tier penalty is \$25,000 (instead of \$75,000), the maximum second-tier penalty is \$50,000 (instead of \$150,000), and the maximum third-tier penalty is \$100,000 (instead of \$250,000).

The Act amends Code Section 6721 to increase the first-tier penalty to \$30 from \$15 and the maximum first-tier penalty to \$250,000 from \$75,000. The second-tier penalty is increased to \$60 from \$30 and the maximum second-tier penalty is increased to \$500,000 from \$150,000. The third-tier penalty is increased to \$100 from \$50 and the maximum third-tier penalty is increased to \$1,500,000 from \$250,000. The minimum penalty for a failure to file due to intentional disregard is increased to \$250 from \$100.

## Client Alert.

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For small businesses, the maximum first-tier penalty is increased under the Act to \$75,000 from \$25,000, the maximum second-tier penalty is increased to \$200,000 from \$50,000, and the maximum third-tier penalty is increased to \$500,000 from \$100,000.

The Act adjusts the failure to file penalty to account for inflation every five years, with the first adjustment to take place in 2012. This part of the Act applies with respect to information returns required to be filed on or after January 1, 2011.

*Code Section 6722.* Code Section 6722 imposes a penalty for the failure to furnish correct payee statements to taxpayers. A \$50 penalty is imposed for each failure to furnish a payee statement, with a maximum penalty of \$100,000. If the failure to furnish is due to intentional disregard, the penalty is increased to the greater of \$100 or a fixed percentage of the aggregate items to be shown on the payee statements. There is no maximum penalty under Code Section 6722 for a failure to furnish correct payee statements.

The Act revises the failure to furnish correct payee statements penalty to provide tiers and caps similar to those applicable to the Code Section 6721 penalty for failure to file a correct information return. Accordingly, if a payee statement is furnished within 30 days after the prescribed date, the penalty is \$30 per statement, with a maximum penalty of \$250,000. If the payee statement is furnished more than 30 days after the prescribed date but on or before August 1, the amount of the penalty is \$60 per statement, with a maximum of \$500,000. If a payee statement is not furnished on or before August 1 of any year, the penalty is \$100 per return, with a maximum of \$1,500,000. The Code Section 6722 failure to furnish penalty is also amended to provide penalty limitations for small businesses and increase penalties for intentional disregard that are the same as those for the Code Section 6721 penalty.

The Code Section 6722 failure to furnish correct payee statements will be adjusted to account for inflation every five years, with the first adjustment to take place in 2012. This part of the Act applies with respect to payee statements required to be furnished on or after January 1, 2011.

### APPLICATION TO CONTINUOUS LEVY TO TAX LIABILITIES OF CERTAIN FEDERAL CONTRACTORS

In general, if a taxpayer has a Federal tax lien attached to the taxpayer's property, the Internal Revenue Service ("IRS") is entitled to seize such property by levy so long as the IRS has provided both notice of the intent to levy and a collections due process notice (i.e., a notice of the right to an administrative hearing) at least thirty days before the levy is made. In addition, under the Federal Payment Levy Program, the IRS is allowed to continuously levy up to 15% of certain "specified payments," such as government payments to Federal contractors who are delinquent on their tax obligations. This continuous levy generally remains in effect until the tax liability is paid or the IRS releases the levy. However, prior to enforcing a continuous levy, the IRS must also provide the taxpayer a notice of the intent to levy and a collections due process notice at least thirty days before the levy is made.

Once a taxpayer receives either of the above notices, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office. Otherwise, after the 30-day notice period expires, the IRS will levy to collect the unpaid tax liability.

The Act changes these general procedural rules with respect to Federal tax liabilities of Federal contractors identified under the Federal Payment Levy Program so that the IRS is now allowed to issue levies prior to the collections due process hearing for such Federal tax liabilities. This means that, with respect to Federal tax liabilities of Federal

## Client Alert.

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contractors identified under the Federal Payment Levy Program, the IRS may begin to levy and collect from the taxpayer much sooner than the IRS could prior to the Act's enactment. This part of the Act applies to levies issued after September 27, 2010.

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