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Clients&FriendsMemo

The Obama Administration's Fiscal Year 2010 Revenue Proposals

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I. Introduction and Summary.

On May 11, 2009, the Treasury Department released the Obama Administration's Revenue Proposals for the fiscal year 2010. This memorandum summarizes some of the proposals that are of most interest to U.S. corporate taxpayers, financial institutions, and investment funds.

In short, the Revenue Proposals would, if enacted:

- Expand the NOL Carryback. Generally, taxpayers may carryback net operating losses for two years. The American Recovery and Reinvestment Act of 2009 extended the carryback for 2008 to five years for businesses with gross receipts of less than $15 million. The President has proposed to work with Congress to extend the carryback period and make it available to more taxpayers, but the Revenue Proposals do not offer additional detail. On May 15, 2009, however, Representatives Richard Neal (D-Massachusetts) and Patrick Tiberi (R-Ohio) introduced legislation (H.R. 2452) that would permit most companies to carry back losses from 2008 or 2009 for up to five years. The bill is identical to S. 823, which was introduced by Senate Finance Committee Chairman Max Baucus (D-Montana) and Senator Olympia Snowe (R-Maine) in April and which was passed by both houses of Congress, but ultimately dropped in committee.

- Make the Research and Experimentation Tax Credit Permanent. Under section 41,[1] taxpayers are entitled to a tax credit of up to 20% of certain research and experimentation expenses, but the R&E credit is currently scheduled to expire on December 31, 2009. The Revenue Proposals would make the R&E credit permanent.

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[1] All reference to section numbers are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations issued thereunder, as amended.

- **Significantly Change the Tax Treatment of U.S. Multinationals.** The Revenue Proposals would make incremental but significant changes to the taxation rules for U.S. multinational corporations.

  - **Treat Second-Tier Disregarded Entities as Corporations for Federal Income Tax Purposes; Extend Section 954(c)(6) Only Through 2010.** The Revenue Proposals would treat any foreign entity with a single owner that is organized or created in a country other than the country of organization of its single owner as a corporation for federal tax purposes. The effect of this proposal would be to cause deductible payments made by a disregarded entity located in a high tax jurisdiction to a CFC located in a low-tax jurisdiction to be taxable Subpart F income. However, by causing disregarded entities to be treated as corporations, the proposal will have significant collateral consequences. The proposal would be effective beginning 2011. The Revenue Proposals would also extend the "look-through" rule of section 954(c)(6) only through 2010. These proposals are discussed in Part II.A. below.

  - **Defer Expenses Relating to Deferred Foreign Income.** The Revenue Proposals would defer the expenses (other than research and experimentation expenditures) of a U.S. taxpayer that are allocable to foreign source income to the extent that the foreign source income is not currently subject to U.S. tax (as determined under the existing section 861 rules). Deferred expenses would be carried forward. The proposal generally permits faster utilization of deferred expenses than the similar proposal introduced in 2008 by Congressman Charles Rangel (D-New York) in H.R. 3970 (the "Rangel bill"). The provision would become effective beginning 2011, and is discussed in Part II.B. below.

  - **Determine Foreign Tax Credits on a Pooling Basis.** The Revenue Proposals would require U.S. taxpayers to determine their deemed paid foreign tax credits for taxes paid by subsidiaries based on the amount of (x) the consolidated foreign taxes paid and (y) the consolidated earnings and profits of all foreign subsidiaries repatriated to the U.S. taxpayer during the taxable year. This proposal would deny the current ability of U.S. taxpayers to pick and choose which income to repatriate for foreign tax credit purposes, which tends to maximize foreign tax credit utilization. The proposal would be effective beginning 2011, and is discussed in Part II.C. below.

  - **Prevent Splitting of Foreign Income and Foreign Taxes.** The Revenue Proposals would reverse the holding of the Guardian Industries case,[2] and prevent U.S. taxpayers from claiming foreign tax credits prior to the recognition of the associated foreign income. The proposal would be effective beginning 2011, and is discussed in Part II.D. below.

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[2] Guardian Industries Corp. v. United States, 477 F.2d 1368 (Fed. Cir. 2007).

- **Tighten the Transfer Pricing Rules.** The Revenue Proposals would provide that (i) the definition of intangible property for purposes of sections 367(d) and 482 includes workforce in place, goodwill, and going concern value, (ii) in a transfer of multiple intangible properties, the IRS may value the intangible properties on an aggregate basis, and (iii) intangible property must be valued at its highest and best use as it would change hands between a willing arm's-length buyer and seller, both having reasonable knowledge of relevant facts. The proposal would be effective beginning 2011.

- **Limit Earning Stripping by Expatriated Entities.** The Revenue Proposals would revise section 163(j) to further limit the ability of a domestic corporation to deduct interest payments made to a related expatriated entity. The proposal would be effective beginning 2011 and is described in Part II.E. below.

- **Treat "Boot-Within-Gain" Repatriation as Dividends.** Under current section 356(a)(1), if a U.S. shareholder receives stock and property or money in exchange for stock of a corporation, the U.S. shareholder recognizes gain equal to the lesser of the gain realized in the exchange or the amount of boot received (known as the "boot within gain" limitation). As a result of this limitation, if the exchanging shareholder has little or no built-in gain in its stock, the shareholder recognizes little or no gain upon the exchange, even if the exchange has the economic effect of a dividend. The Revenue Proposals would require a U.S. shareholder that receives stock and property or money from a foreign acquiring corporation to treat the property or money as a dividend if the exchange has the effect of the distribution of a dividend, even if the shareholder has no built-in gain in the stock. The proposal would not affect exchanges in domestic acquisitions. The proposal would be effective beginning in 2011.

- **Treat Income Generated from "Carried Interests" as Ordinary Income.** The Revenue Proposals would enact the controversial "carried interest" proposal and treat all income and gain received from a carried interest in a partnership that is received by a partner in exchange for services as ordinary income. The proposal is broader than the proposal introduced at the end of 2007 by Congressman Rangel.[3] The proposal would apply to any carried interest received for services (and not only to carried interests received for investment management services provided to investment funds). The proposal would be effective beginning 2011, and is discussed in Part III below.

- **Repeal the LIFO Method of Accounting for Inventories.** The Revenue Proposals would require taxpayers that currently use the LIFO (last-in, first-out) method of inventory

[3] H.R. 6275.

accounting to change to the FIFO (first-in, first-out) method in 2011. In addition, taxpayers would be required to report the difference between the LIFO and FIFO value of their inventory ratably over the eight taxable years beginning in the first taxable year after December 31, 2011.

- Dividend Withholding on Equity Swaps and Security Loans. The Revenue Proposals would impose U.S. withholding tax on substitute dividend payments made on equity swaps unless the swaps relate to a relatively small position on very actively traded securities and certain other requirements are satisfied. The proposal would also reform Notice 97-66,[4] which has allowed substitute dividend payments on securities loans to escape U.S. withholding taxes. The proposal would be effective beginning 2011, and is discussed in Part II.F. below.

- Withholding and Information Reporting Changes. The Revenue Proposals would significantly increase withholding and information reporting requirements. These proposals are discussed in Part II.G. below.

  - Require Withholding on Interest, Dividend, and Other "FDAP" Payments to Foreign Intermediaries That Are Not "Qualified Intermediaries." The Revenue Proposals would impose a 30% withholding tax on interest, dividends, and other "fixed or determinable, annual or periodic" ("FDAP") payments to a financial institution or other intermediary unless the intermediary has entered into a "qualified intermediary" agreement with the IRS. The proposal would be effective for payments made after December 31 of the year of enactment.

  - Backup Withholding. In addition, under the Revenue Proposals, a 20% withholding tax would be imposed on the gross proceeds from the sale of certain securities paid to a nonqualified intermediary that is located in a jurisdiction that does not have a comprehensive income tax treaty with the United States that includes a satisfactory exchange of information program.

  - Increased Reporting by Qualified Intermediaries. Under the Revenue Proposals, a foreign financial institution would not qualify as a qualified intermediary unless it identifies all of its account holders that are U.S. persons. The financial institution would also be required to report all reportable payments received on behalf of U.S. account holders. In addition, Treasury would be authorized to extend similar rules to affiliates of the financial

[4] 1997-2 C.B.328.

institution.

- **Require Information Reporting on Payments to Corporations.** Under current law, taxpayers making payments to corporations are not required to send a Form 1099 to the IRS with respect to the payment.[5] The Revenue Proposals would require taxpayers that are engaged in business and make a payment of more than $600 to a corporation other than a tax-exempt corporation to report the payments to the recipient and to the IRS on Form 1099. The proposal would be effective beginning 2010.

- **Increase Information Reporting by Financial Institutions and Other Withholding Agents.** The Revenue Proposals would dramatically increase the obligations of U.S. financial institutions and certain other taxpayers to obtain information from foreign account holders and other payees and report it to the IRS. For example:

  - Qualified intermediaries would be obligated to identify all account holders that are U.S. persons;

  - U.S. individuals would be required to report any transfer of money or property to or from a foreign bank, brokerage, or other financial account by the U.S. individuals;

  - Taxpayers that must report interests or signature authority in foreign bank and financial accounts would be subject to additional disclosure on their tax returns; and

  - Third-parties would be subject to reporting requirements with respect to transfers to and from foreign accounts by U.S. persons and in connection with the acquisition or formation of a foreign business entity on behalf of a U.S. individual.

  These proposals would generally be effective in the taxable year following the year of enactment.

- **Accrual of Interest Income on Forward Sale of a Corporation's Own Stock.** Under current law, corporations do not recognize gain or loss upon the forward sale of their stock.[6] The proposal would treat a portion of the forward payment received by a corporation on a "postpaid" forward contract to sell its own stock as interest (rather than exclude it entirely). The proposal would be effective beginning 2011.

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[5] Treasury regulations section 1.6049-4(c)(1)(ii)(A).

[6] Section 1032.

- **Codify the "Economic Substance Doctrine".** The Revenue Proposals would codify the judicial "economic substance doctrine". Under the proposal, taxpayers would be required to demonstrate that a transaction changes the taxpayer's economic position in a meaningful way (apart from federal tax effects) and the taxpayer has a substantial non-federal-tax business purpose for entering into the transaction. Taxpayers that fail to satisfy this test will be denied the tax benefits sought and will be subject to a mandatory 30% penalty on the understatement (or 20% if the taxpayer previously disclosed the transaction to the IRS). The proposal is substantially similar to the provision in the Rangel bill, and in the Stop Tax Havens Abuse Act (S. 506), introduced earlier this year by Senator Carl Levin (D-Michigan) (the "Levin bill"), except that the maximum penalty under the Rangel bill is 40%. The proposal would be effective with respect to transactions entered into after the date of enactment.

- **Treat the Gain and Loss of Dealers from Section 1256 Contracts as Ordinary Gain or Loss.** Under current law, commodities dealers, commodities derivatives dealers, dealers in securities, and option dealers are subject to mark-to-market treatment each year on their "section 1256 contracts,"[7] but the gain or loss is treated as 60% long-term and 40% short-term capital gain.[8] The Revenue Proposals would treat all gain and loss realized by dealers from section 1256 contracts as ordinary income or loss. The proposal would be effective for taxable years beginning after the date of enactment.

II. International Tax Provisions.

A. Proposal to Treat Second-Tier Disregarded Entities as Corporations for Federal Income Tax Purposes; Extension of Section 954(c)(6) Only Through 2010.

1. Background. Under Subpart F of the Code, as originally enacted, if one "controlled foreign corporation" (a "CFC")[9] of a "United States shareholder"[10] made a payment of interest, dividends or royalties to another CFC of the United States shareholder, the payment was generally treated as "Subpart F income" and taxable to the United States shareholder unless, under the "same country exception," the recipient CFC was organized

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7 Very generally, section 1256 contracts include regulated futures contracts, nonequity options, dealer equity options, and dealer securities future contracts that are traded on or subject to the rules of a qualified board or exchange, as well as many foreign currency contracts. See section 1256.

8 Section 1256.

9 A CFC is, in general, a foreign corporation of which more than 50% of the combined voting power or value of all classes of the corporation's stock is owned (directly or through attribution) by U.S. persons that each own (directly or through attribution) stock in the corporation with 10% or more of the total voting power. See sections 957(a) and 951(b).

10 A United States shareholder is a United States person that owns (directly or through attribution) stock in a CFC that is entitled to 10% or more of the total voting power.

in the same country as the payor CFC.[11] In 1996, the IRS issued the "check-the-box" regulations, which allow U.S. corporations to elect to treat certain foreign entities as partnerships (if they have two or more owners) or "disregarded entities" (if they have one owner) for federal income tax purposes.

The check-the-box regulations allow U.S. multinationals to reduce the foreign tax liability of their foreign subsidiaries without generating Subpart F income. For example, a U.S. multinational may organize a holding company in a low-tax jurisdiction (like Ireland) and have the holding company organize its operating subsidiaries in high tax jurisdictions (such as Germany). If the U.S. multinational elects to treat the operating subsidiaries as disregarded entities for U.S. tax purposes and causes them to make deductible interest or royalty payments to the low-tax holding company, the U.S. multinational could successfully reduce the foreign tax liability of its foreign subsidiaries, transfer cash to the low tax jurisdiction and, because the operating companies are disregarded for U.S. tax purposes, the payments would not generate Subpart F income.

In February 1998, the Clinton Administration issued Notice 98-11,[12] which announced that regulations would be issued that would treat payments made by entities that are treated as corporations for foreign tax purposes but as disregarded entities for U.S. tax purposes ("hybrid entities") as Subpart F income. These regulations were issued in temporary form in early 1998.

However, Congress objected to the regulations and, after legislation was introduced that would prohibit their implementation, the temporary regulations were withdrawn.

Subsequently, in 2006, Congress enacted section 954(c)(6), which exempts dividends, interest, rents and royalties received by one CFC from another related CFC as Subpart F income unless and only to the extent that the payment is allocable to Subpart F income (or income that is effectively connected with a U.S. trade or business) of the payor. Effectively, section 954(c)(6) expands the same country exception and codifies many of the Subpart F planning opportunities presented by the check-the-box regulations. Section 954(c)(6) is scheduled to expire at the end of 2009.

2. The Proposal. The Revenue Proposals would extend section 954(c)(6) through 2010, but then allow it to lapse.

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[11] Treasury regulations section 1.954-2(b)(4).

[12] 1998-1 C.B. 433.

In addition, as of January 1, 2011, the proposal would treat any foreign entity with a single owner that is organized or created in a country other than that of the single owner as a corporation for federal tax purposes. The effect of the proposal will be to cause the deductible payments formerly made by a disregarded entity located in a high tax jurisdiction to its sole owner located in a low tax jurisdiction to be taxable Subpart F income.

However, in contrast to Notice 98-11, which would have treated payments by a hybrid entity as Subpart F income but would otherwise have respected the check-the-box election, under the Revenue Proposals, the disqualified foreign entity would be converted into a foreign corporation for all purposes in 2011. Accordingly, the conversion would be treated as a contribution by the first-tier CFC of the assets of the foreign disregarded entity to a new CFC. This contribution may be a taxable transaction to the first-tier CFC (and therefore to the ultimate U.S. parent) under Subchapter C (including possibly by reason of section 367). Moreover, the conversion of a disregarded entity into a corporation may trigger recapture of dual consolidated losses. These collateral consequences of the proposal will apply somewhat arbitrarily to some taxpayers (but not others) and appear entirely unrelated to the proposal's objective to curtail deferral of foreign income.

Finally, the proposal provides that, except in cases of U.S. tax avoidance, it will generally not disqualify first-tier eligible entities wholly owned by a United States person from electing disregarded status. Thus, a U.S. person could form a foreign entity and elect to treat the foreign entity as a disregarded entity. It is unclear whether that disregarded foreign entity could, in turn, form a second-tier subsidiary and the U.S. parent could elect to treat the second-tier subsidiary as a disregarded entity.

B. Defer Expenses Relating to Deferred Foreign Income.

1. Background. Under current law, U.S. taxpayers may currently deduct interest and other ordinary and necessary business expenses, including expenses properly allocable to unrepatriated foreign-source income that is deferred and not subject to current tax.

2. The Proposal. The Revenue Proposals would require a taxpayer to defer its deductions (other than research and experimentation deductions) that are allocable to foreign-source income that is not currently subject to U.S. tax. Any deferred deductions would be carried forward indefinitely and generally treated as current year expenses in determining the allowed deduction for expenses in any subsequent year.

The proposal is similar to the analogous proposal in the Rangel bill, although the Administration's proposal is more generous in one respect. Under the Rangel bill, deferred deductions would be placed in a separate pool from current year deductions and would be allowed as deductions in subsequent years only to the extent that previously deferred earnings are repatriated. However, under the Administration's proposal, deferred deductions would be allowable as deductions in a subsequent year as long as there is sufficient foreign-source income subject to U.S. tax in that year, regardless of whether any previously deferred income is repatriated in the subsequent year. In addition, the Administration's proposal does not mention repeal of worldwide interest allocation, which was enacted in 2004, but is not proposed to become effective until 2011.[13] The Rangel bill would repeal worldwide interest allocation.

C. Determine Foreign Tax Credits on a Pooling Basis.

1. Background. Under current law, a U.S. taxpayer is deemed to have paid a portion of foreign taxes paid by its foreign subsidiary in an amount proportionate to the ratio of (x) the dividend paid by the subsidiary to (y) the subsidiary's earnings and profits.[14] The deemed paid foreign tax credit is generally capped at an amount equal to the U.S. taxpayer's pre-credit U.S. tax on the taxpayer's aggregate foreign-source income,[15] with the cap applying separately to all foreign-source "passive" income and all "general" income.[16] As a result, U.S. taxpayers can selectively repatriate income from subsidiaries located in high-tax jurisdictions in order to maximize use of the U.S. taxpayer's available deemed paid foreign tax credits, and to defer income on earnings of subsidiaries located in low-tax jurisdictions.

2. The Proposal. The Revenue Proposals would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis, and would pool all of its foreign taxes paid and earnings and profits repatriated to the U.S. taxpayer in the taxable year from each of its foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit for the taxable year. The deemed paid foreign tax credit would be determined based on the amount of the consolidated earnings and profits of all of the foreign subsidiaries repatriated to the U.S. taxpayer during that taxable year. The proposal is designed to create a blended foreign tax rate with respect to a U.S. taxpayer's foreign

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[13] Very generally, section 864(f) provides affiliated groups the ability to make a one-time election to allocate the interest expense of the entire worldwide group as if all members of the worldwide group were a single corporation (rather than allocate only the interest expenses of the domestic affiliates, as under current law). For multinationals with significant foreign debt, this election may permit the taxpayer to allocate some of its foreign debt to U.S. source income, and potentially increase its foreign source income subject to U.S. income tax and correspondingly increase the amount of foreign tax credits the taxpayer may use.

[14] Section 902.

[15] Section 901 and 904.

[16] Section 904(d).

source income (including dividend distributions from its foreign subsidiaries), and therefore is designed to prevent taxpayers from selectively repatriating high-taxed income.

The Administration's proposal is similar to an analogous proposal in the Rangel bill, but is more generous to taxpayers. First, the Rangel bill provides that any previously deferred foreign income taxes would be allowed in a subsequent year only in proportion to the amount of previously deferred foreign income repatriated in that year. The Administration's proposal does not appear to impose this limitation. Second, the Administration's proposal clearly applies only to deemed paid foreign tax credits, and not to general tax credits. The Rangel bill is unclear on this point.

D. Prevent Splitting of Foreign Income and Foreign Taxes.

1. **Background.** Under current law, a taxpayer is entitled to foreign tax credits if foreign law imposes on the taxpayer a legal liability for the tax, regardless of whether the taxpayer is required to include the associated earnings into income.[17] In Guardian Industries,[18] the taxpayer organized a domestic corporate subsidiary holding company which, in turn, organized a Luxembourg subsidiary that was disregarded for U.S. tax purposes but treated as a corporation for Luxembourg purposes (i.e., a hybrid entity). The hybrid entity, in turn, organized a number of operating subsidiaries that were respected as corporations for both Luxembourg and U.S. tax purposes. Under Luxembourg law, the tax liability was imposed on the hybrid entity. The Guardian court held that, because the hybrid entity was disregarded for U.S. tax purposes, for purposes of the foreign income tax credit, the domestic holding company was liable for the Luxembourg tax. Consequently, because the foreign tax credit was deemed to be imposed (through the hybrid entity) on the U.S. parent, but the income was deemed to be earned by CFCs and (because it was not Subpart F income) deferred, the U.S. taxpayer was entitled to a foreign tax credit, but could continue to defer tax on the income earned by the foreign operating subsidiaries.

2. **The Proposal.** The Revenue Proposal's would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. The matching rule would deny foreign tax credits to U.S. taxpayers (such as Guardian) that do not report the associated foreign income.

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[17] Treasury regulations section 1.901-2(f)(1) (the taxpayer on whom foreign law imposes "legal liability" for the tax is the person by whom tax is considered paid).

[18] See Guardian Industries Corp. v. United States, 477 F.3d 1368 (Fed. Cir. 2007).

E. Limit Earnings Stripping By Expatriated Entities

1. Background. Very generally, if a domestic corporation pays interest to a related foreign person, and the corporation has a debt-to-equity ratio of greater than 1.5 to 1, section 163(j) denies the domestic corporation interest deductions to the extent that the corporation's net interest expense exceeds 50% of the corporation's adjusted taxable income. Interest expense that is disallowed under section 163(j) may be carried forward indefinitely and, to the extent 50% of the corporation's adjusted taxable income in a subsequent year exceeds its net interest expense, the excess may be carried forward to the three subsequent tax years to increase the corporation's adjusted taxable income for such years. In 2003, Congress enacted section 7874, which provides that if a U.S. parent corporation is acquired by a foreign parent in certain transactions, the foreign parent is treated as a domestic corporation or the former U.S. parent is required to recognize gain. U.S. parent companies that are acquired in transactions described in section 7874 are referred to as "expatriated entities." In a recent study,[19] the Treasury Department found evidence that expatriated entities have been using earnings stripping to reduce their U.S. tax.

2. The Proposal. The Revenue Proposals would revise section 163(j) as it applies to payments made by expatriated entities to related foreign corporations. For expatriated entities, the debt-to-equity safe harbor would be eliminated and the 50% adjusted taxable income threshold for the limitation would generally be reduced to 25% of adjusted taxable income. (However, the 50% threshold would remain with respect to interest paid to unrelated parties on debt that is subject to a related-party guarantee.) Finally, for expatriated entities, the carryforward for disallowed interest would be limited to ten years and the carryforward of excess limitation would be eliminated.

F. Withholding on Equity Swaps and Securities Loans.

1. Background. Under current law, payments of U.S. source dividends to non-U.S. persons are generally subject to a 30% withholding tax and substitute dividend payments on securities loans, sale-repurchase agreements and substantially similar agreements are subject to a 30% withholding tax.[20] However, dividend equivalent amounts paid to a non-U.S. person under an equity swap are generally sourced by reference to the residence of

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[19] See "Report to the Congress on Earnings Stripping, Transfer Pricing and US Income Tax Treaties" (November 28, 2007) at www.treas.gov/offices/tax-policy/library/ajca2007.pdf.

[20] Treasury regulations section 1.861-3(a)(6); (substitute dividend payments on security loans and sale-repurchase agreements are sourced in the same manner as the underlying dividend).

the payee and, therefore, for a foreign payee, are not subject to withholding.[21] Moreover, under Notice 97-66, if a securities loan or sale-repurchase agreement is between foreign persons, and the payor would be subject to a 30% withholding tax on U.S. source dividends, the substitute payments made by the payor are exempt from U.S. withholding tax.

Foreigners have combined Notice 97-66 with the rule that eliminates withholding on dividend equivalent payments under an equity swap to avoid withholding with respect to substitute dividend payments under securities lending agreements.[22]

In September 2008, the U.S. Senate Permanent Subcommittee on Investigations held hearings on abuses with respect to dividend withholding. Following those hearings, in March 2009, Senator Carl Levin proposed the Stop Tax Havens Abuse Act, which very generally would impose a 30% dividend withholding tax on substitute dividend payments made under swaps or security loans that reference U.S. securities.

2. The Proposal. The Administration's proposal is significantly more favorable for taxpayers than Senator Levin's proposal. Very generally, under the Administration's proposal, foreign taxpayers may enter into equity swaps on portfolio positions, receive substitute dividend payments and avoid the dividend withholding tax to which they would be subject if they purchased the underlying equity security directly, so long as the equity swap satisfies the following conditions:

1. the terms of the equity swap do not require the foreign person to post more than 20% of the value of the underlying stock as collateral;

2. the terms of the equity swap do not include any provision addressing the hedge position of the counterparty to the transaction;

3. the underlying stock is publicly traded and the notional amount of the swap represents less than 5% of the total public float of that class of stock and less than

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21 See Treasury regulations section 1.863-7(b) (the source of notional principal contract income is determined by reference to the residence of the recipient).

22 More specifically, under the transaction, a foreign taxpayer subject to a 30% withholding tax on dividends would loan U.S. equity securities to a second foreign taxpayer that is also subject to a 30% withholding tax on dividends, and the borrower would sell the stock and enter into an equity swap that hedges its obligations under the securities borrowing. Under Notice 97-66, because the security lender and borrower are each subject to 30% withholding tax, no dividend withholding tax would be imposed on the substitute dividend payments and, under regulations section 1.863-7(b), no withholding would be imposed on the dividend equivalent payment made under the equity swap. Consequently, the securities lender may receive substitute dividend payments free of U.S. withholding tax, and the security borrower would be hedged.

20% of the 30-day average daily trading volume;

4. the foreign person does not sell the stock to the counterparty at the inception of the contract (i.e., “cross-in”) or buy the stock from the counterparty at the termination of the contract (i.e., “cross-out”);

5. the prices of the equity that are used to measure the parties’ entitlements or obligations are based on objectively observable prices; and

6. the swap has a term of at least 90 days.[23]

The proposal begs a broader question: If Congress is inclined to enact the proposal and affirmatively provide that a foreign portfolio investor should not be subject to withholding on an equity swap that satisfies these conditions, why should the foreigner be subject to withholding when it holds the equivalent position directly? The only substantive difference between an equity swap that satisfies the conditions of the proposal and actual ownership is that the conditions would effectively require the foreign investor to assume credit risk of its counterparty and leverage its investment on a 4-1 basis (20% collateral). There is no evident tax or other policy that is advanced by imposing these conditions. Moreover, the proposal would effectively prohibit U.S. financial institutions from taking more than 20% collateral for equity swaps from their foreign counterparties. This prohibition appears contrary to the Administration’s broader policy objective to stabilize the country’s financial institutions. We believe that this prohibition on more than 20% collateral will significantly reduce the attractiveness of the proposal for U.S. financial institutions and would, if enacted, inevitably lead to complicated structures that offer financial institutions greater protection against default by their counterparties.

In addition, the proposal presents the following issues and open questions:

First, the proposal requires that the prices of the equity that is used to measure the parties’ entitlements or obligations be based on objectively observable prices. We assume that “market-on-open,” “market-on-close,” volume-weighted average price (“VWAP”) and time-weighted average price (“TWAP”) satisfy this standard. However, we would expect that the proposal will require time-weighted and volume-weighted prices to be based on a meaningful period of time (e.g., a one second time-weighted price would be prohibited).

[23] We would expect that tax-exempts will likewise rely on the safe harbor to conclude that a long position under an equity swap that qualifies for the safe harbor is not a direct leveraged purchase of the shares by the tax-exempt person which may result in unrelated business taxable income.

Second, it is an open question under the proposal whether the termination price of a swap may reference the counterparty's exit price for its hedge. On the one hand, such a price is both objective and observable, and a provision in a swap that provides for a termination price equal to the counterparty's exit price does not permit a taxpayer to dictate its counterparty's hedge. However, such a provision could be viewed as "addressing" the counterparty's hedge in violation of the second condition in the proposal.

Third, the proposal requires the swap to have a term of 90 days. It is unclear whether this condition would be violated if the swap is terminated prior to 90 days for valid business reasons. It is equally unclear how a U.S. withholding agent would determine its obligations with respect to substitute dividend payments under a swap that has been outstanding for less than 90 days. Must the withholding agent withhold until the 90th day?

Fourth, the proposal requires that the notional amount of the swap must represent less than 5% of the total public float of that class of stock. We would expect that this condition must be met only at the inception of the swap, and a swap would not be disqualified if the issuer of the underlying stock buys back its outstanding stock after the swap's inception.

Fifth, the proposal requires that the swap reference less than 20% of the 30-day average daily trading volume. We would expect that this condition as well must be met only at the inception of the swap, and is not thereafter violated if the underlying stock becomes less actively traded.

Finally, the Revenue Proposals provide that Notice 97-66 should be revoked, and new guidance issued that eliminates securities loans that improperly eliminate withholding tax on dividends (but minimizes over-withholding). It is unclear what this guidance will provide.

G. Changes to Withholding Rules.

1. Background. Under current law, withholding agents may make a payment to a foreign intermediary without deducting "regular" or "backup" withholding tax[24] so long as the intermediary has entered into a "withholding agreement" with the IRS under which the

[24] In general, section 3406 provides that payors of payments to "non-exempt recipients" must deduct and withhold a 28% tax (referred to as backup withholding). Under current law, exempt recipients generally include corporations (although the Revenue Proposals intend to remove corporations from the list of exempt recipients), tax-exempt organizations, the United States or any foreign government or any political subdivision or instrumentality of the United States or a foreign government and certain other persons. Currently, a payee is generally not subject to backup withholding if it provides the withholding agent with either (i) the payee's taxpayer identification number and a certification from the payee that it is not subject to backup withholding (typically on an IRS Form W-9) or (ii) certification that the payee is not a U.S. person (typically on an IRS Form W-8).

intermediary agrees to bear primary responsibility for all withholding obligations (in which case the intermediary would be a "qualified intermediary") or, if the intermediary has not entered into such an agreement (and therefore is a "nonqualified intermediary"), the intermediary provides the withholding agent with an IRS Form W-8IMY and appropriate tax forms for all of the beneficial owners of the payment. Under current law, withholding agents may rely on certification and documentation provided by payees unless the agent knows or has reason to know that the documentation provided is incorrect or unreliable.[25]

Recently, the IRS investigated offshore tax fraud involving U.S. taxpayers, and UBS entered into a $780 million settlement with the United States with respect to payments to U.S. accountholders that UBS did not report to the IRS and failed to backup withhold.

2. The Proposal. The Revenue Proposals would:

1. Require withholding agents to withhold 30% on FDAP payments made to a nonqualified intermediary. The proposal anticipates that exceptions may be made for payments that Treasury concludes present a low risk of tax evasion. Foreign payees that are subject to overwithholding may apply to the IRS for a refund. This proposal effectively would prohibit the use of nonqualified intermediaries.

2. Require withholding agents to withhold 30% on FDAP payments made to foreign corporations and partnerships, unless the foreign entity provides documentation regarding the entity's beneficial owners. Exceptions may be made for payments to publicly traded companies, foreign governments, pension funds, widely-held investment vehicles, and certain other entities.

3. Require withholding agents to withhold 20% of the gross proceeds from the sale of a security paid to a nonqualified intermediary that is resident in a jurisdiction with which the United States does not have a satisfactory exchange of information program. The intermediary may apply to Treasury for a refund if it identifies all of its direct U.S. account holders and reports all payments received on behalf of the U.S. account holders. Foreign payees may apply directly to Treasury for a refund.

The Revenue Proposals indicate that "the rules will be designed so as not to disrupt ordinary and customary market transactions." However, it is unclear whether only future ordinary and customary market transactions will be protected from disruption, or transactions that are outstanding when the Revenue Proposals become effective in 2011.

[25] Treasury regulations section 1.1441-7(b)(1).

For example, U.S. debt issuers in the capital markets and U.S. parties to derivative contracts regularly agree to "gross up" and indemnify their lenders and counterparties for U.S. withholding tax, including in certain cases withholding tax that arises from increased reporting obligations. Accordingly, if the Revenue Proposals apply to outstanding debt obligations and derivatives, U.S. debt issuers and U.S. parties to derivative contracts may be required to bear the cost of any withholding tax.

III. Treatment of Income from Carried Interests for Services as Ordinary Income.

1. Background. Under current law, the grant to a person of a partnership interest in exchange for services (known as a carried interest or profits interest) is not a taxable event.[26] Moreover, income and gain allocated to the service provider retains the character of the income earned by the partnership. Thus, if the partnership recognizes a long-term capital gain and a portion of that gain is allocated to a service provider pursuant to the carried interest, the service provider recognizes long-term capital gain, which is currently taxable at a maximum rate of 15% (which is proposed to be increased to 20% under the Revenue Proposals).

In 2007, Congressmen Sander Levin (D-Michigan),[27] and Charles Rangel,[28] each introduced legislation that would tax as ordinary income all income received from a profits interests, and held by a person that provides services to the partnership with respect to certain assets (including stock, debt, swaps, real estate, commodities, options, and derivative contracts).[29] Moreover, the Rangel and Levin proposals would impose a corporate tax on publicly-traded partnerships (such as Blackstone and Fortress) that hold carried interests and provide services to underlying funds.

2. The Proposal. The Administration's proposal is similar to the Rangel proposal, but applies to profits interests received for services provided to any partnership, and not only a partnership that provides investment services.

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[26] See Revenue Procedure 93-27, 1993-2 C.B. 343 (IRS will not challenge the receipt of a profits interest as a nontaxable event). Very generally, a carried interest entitles a partner to a share of future profits but does not provide the partner with a current capital account.

[27] H.R. 2834.

[28] H.R. 3996.

[29] Senators Baucus and Grassley (R-Iowa) introduced a bill (S. 1624) that would treat a publicly traded partnership providing investment advisory services as a corporation. This bill did not address the character of the income received by the holder of a carried interest.

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