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Clients&FriendsMemo

# Tax Proposals in the Obama Administration's Fiscal Year 2012 Revenue Budget

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## I. Introduction

On Monday, the Treasury Department released the Obama Administration's Fiscal Year 2012 Revenue Proposals (the "**Greenbook**"). This memorandum summarizes the tax proposals that are of most interest to U.S. corporate taxpayers, financial institutions, insurance companies, hedge funds, private equity funds, and high-income individuals.[1]

The Greenbook generally reproposes all of last year's Greenbook proposals that were not enacted into law,[2] and also adds a handful of new provisions, the most relevant of which are discussed in Part VIII below.

In short, the proposals in the Greenbook would, if enacted:

- Increase Tax Rates and Reduce the Value of Deductions for High-Income Individuals.
    - Beginning in 2013, tax rates will increase to the tax rates that existed prior to the enactment of the Economic Growth Tax Relief Reconciliation Act of 2001 (i.e., the Bush tax cuts will expire), unless Congress extends the existing rates. Thus, the highest individual income tax rate will increase from 35% to 39.6%, the 33% rate would increase to 36%, the maximum

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[1] The Greenbook also provides for a number of proposals with respect to energy-related tax provisions. We discuss those provisions in a separate memorandum that can be found at http://www.cadwalader.com/assets/client_friend/021711EnergyTaxProvisionin2012Budget.pdf.

[2] The proposals from last year's Greenbook that were enacted into law include (i) increased foreign account reporting ("FATCA"; sections 1471-1474), (ii) provisions for withholding on equity swaps and securities loans (section 871(m)), (iii) the repeal of the 80/20 company rules, (iv) the codification of the economic substance doctrine (section 7701(o)), and (v) rules to prevent splitting of foreign income and foreign taxes for tax credit purposes (section 909).

All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations issued thereunder.

rate for long-term capital gains will increase from 15% to 20%, and all dividends (including qualified dividends) will be taxed at ordinary tax rates up to 39.6%. The Greenbook proposes to limit the maximum tax rate on qualified dividends to 20% (i.e., retain this provision of the Bush tax cuts) but allow the other rates to increase starting in 2013.

- The Greenbook reproposes last year's proposal to reinstate the "personal exemption phase-out" for married taxpayers filing jointly with adjusted gross income of at least $250,000, and for single taxpayers with adjusted gross income of at least $200,000. Accordingly, under the proposal, the personal exemption for these taxpayers would be reduced. This proposal would be effective beginning in 2013.
- Finally, the Greenbook reproposes last year's proposal to limit the tax value of itemized deductions (including, apparently, deductions for charitable contributions, state and local taxes, amortizable bond premium, mortgage and investment interest expense, and miscellaneous itemized deductions) to 28% for taxpayers in the 35% tax bracket and for joint return taxpayers in the 33% tax bracket who have an income above $250,000 or individual return taxpayers who have an income above $200,000 (and, in 2013, for taxpayers in the 39.6% or 36% tax brackets). A similar provision would apply under the AMT. This proposal would be effective beginning in 2012.

- Repeal Form 1099 Reporting Requirements on Payments to Corporations. The Patient Protection and Affordable Care Act of 2010 (i.e., the healthcare act) enacted section 6041(i), which requires taxpayers to file an IRS Form 1099, if the taxpayer makes annual payments of $600 or more in connection with a trade or business to a corporation after December 31, 2011,[3] or a taxpayer pays $600 or more in consideration for property.[4] The Greenbook proposes to repeal the IRS Form 1099 requirement with respect to payments for property. It would otherwise retain the reporting requirement for payments to corporations, but authorizes the IRS to make appropriate exceptions where reporting would be especially burdensome.
- Impose a Financial Crisis Responsibility Fee on Financial Firms. The Greenbook reproposes the nondeductible "financial crisis responsibility fee."

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3 Under current law and until section 6041(i) becomes effective, payments made to corporations are exempt from IRS Form 1099 reporting requirements.

4 Under current law and until section 6041(i) becomes effective, an IRS Form 1099 is required only on payments of $600 or more for services.

However, the fee would be approximately 0.075% (in contrast to last year's proposal of a 0.15% fee) on certain liabilities of financial institutions with consolidated assets of $50 billion or more. The fee would apply as of January 1, 2013.

- **Tax Carried Interests as Ordinary Income.** The Greenbook reproposes to treat income and gain from a carried interest in a partnership that is received in exchange for services as ordinary income that is subject to self-employment tax. However, in contrast to last year's proposal, the proposal would apply only to certain investment partnerships (rather than all partnerships). The Greenbook proposal would be effective beginning on January 1, 2012. Part V below discusses the carried interest proposal and the difference between this year's proposal and last year's proposal.

- **Defer Interest Expense Allocable to Untaxed Foreign-Source Income; Determine the "Deemed Paid" Foreign Tax Credit on a Pooled Basis.** The Greenbook reproposes last year's proposal to defer a U.S. taxpayer's deduction of interest expense that is allocable to untaxed foreign-source income. The Greenbook also reproposes last year's proposal that U.S. taxpayers determine their "deemed paid" foreign tax credit on a pooled basis rather than on a selective basis as under current law. These proposals would become effective beginning in January 1, 2012.

- **Repeal the LIFO Method of Accounting for Inventories, the Lower-of-Cost-or-Market, and the "Subnormal Goods" Methods of Accounting for Inventories.** The Greenbook reproposes last year's proposals to repeal the last-in-first-out ("**LIFO**"), the lower-of-cost-or-market, and the subnormal goods methods of accounting for inventories. Taxpayers using LIFO generally would be required to report the difference between the LIFO and first-in-first-out ("**FIFO**") value of their inventory ratably over the ten taxable years between 2013 and 2023. Taxpayers using the lower-of-cost-or-market and the subnormal goods method would be required to report the increased tax value of their inventory ratably over a four-year period, as under last year's proposal. These proposals would be effective for taxable years beginning January 1, 2013.

- **Simplify the "Fractions Rule."** The Greenbook proposes to simplify the "fractions rule." Under the fractions rule, certain pension funds and educational organizations can avoid tax on debt-financed income from a real estate partnership if the partnership's allocations satisfy certain restrictive rules. The proposal would replace the fractions rule with a simpler anti-abuse rule.

- **Repeal Non-Qualified Preferred Stock Rules.** The Greenbook proposes to repeal current law that treats non-qualified preferred stock received in a reorganization as taxable "boot."
- **Enhance and Make Permanent the Research and Experimentation (R&E) Tax Credit.** Under current law, a credit of as much as 20% of research expenses above a base amount is available for taxpayers conducting research. Alternatively, a taxpayer may elect a credit of as much as 14% of research expenses that exceed 50% of the average of those expenses for the three prior taxable years. The credit is set to expire at the end of this year. The Greenbook proposes to make the credit permanent, and to increase the 14% alternative credit to 17%.

The balance of this memorandum is divided into seven parts: Part II discusses the financial crisis responsibility fee; Part III discusses provisions relating to corporations; Part IV discusses the international tax provisions; Part V discusses the carried interest proposal; Part VI discusses provisions relating to dealers; Part VII discusses life insurance provisions; and Part VIII discusses certain other provisions.

## II. Financial Crisis Responsibility Fee

The Greenbook proposes a nondeductible "financial crisis responsibility fee" of approximately 0.075% (in contrast to last year's proposal of a 0.15% fee) on certain liabilities of U.S. financial institutions (and on non-U.S. based financial institutions based on the liability of their U.S. subsidiaries) with consolidated assets of $50 billion or more.

More specifically, the proposal would assess a fee on banks, thrifts, bank and thrift holding companies, brokers, and securities dealers; U.S. companies owning or controlling these types of entities as of January 14, 2010 would also be subject to the fee. The fee would be imposed on worldwide consolidated liabilities of U.S. financial firms, and on non-U.S. based financial firms based on the liabilities of their U.S. subsidiaries. The fee base would not include FDIC-assessed deposits of firms that own depositary institutions, and certain policy-related liabilities of insurance companies.

The fee would apply beginning in 2013.

## III. Corporations

### A. Accrual of Interest Income on the Forward Sale of a Corporation's Own Stock

The Greenbook reproposes last year's proposal that would require a corporation to accrue interest income on the forward sale of its own stock. Under current law, a corporation does not recognize gain or loss upon the forward sale of its own stock.[5] 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 in 2013.

### B. Treat "Boot-Within-Gain" Repatriation as Dividends

The Greenbook reproposes last year's proposal to repeal the "boot-within-gain" limitation. Under current law, if a U.S. shareholder of an acquired corporation receives stock, and "boot" consisting of property or money, in exchange for their stock, the U.S. shareholder recognizes gain equal to the lesser of the gain realized in the exchange and the amount of boot. As a result of this "boot within gain" 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 Greenbook would repeal the boot-within-gain limitation and therefore would require a U.S. shareholder that receives stock, and property or money, from an 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.[6] The proposal would be effective beginning in 2013.

### C. Modify the Definition of "Control" for Section 249 Purposes

The Greenbook reproposes last year's proposal that would expand the definition of control for purposes of section 249.

Under current law, if a corporation repurchases a debt instrument that is convertible into its stock, or into stock of a corporation in control of, or controlled by, the corporation, section 249 may disallow or limit the issuer's deduction for a premium paid to repurchase the debt instrument.[7] For

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5 Section 1032.

6 In general, in making the determination of whether the exchange has the effect of the distribution of a dividend, the taxpayer must look to the earnings and profits of the acquirer corporation. Section 356(a).

7 The issuing corporation's deduction will generally be disallowed to the extent the repurchase price exceeds the adjusted issue price of the debt plus the normal call premium for a nonconvertible bond. Therefore, the corporation may deduct only

this purpose, the definition of "control" includes only a parent corporation and its wholly-owned subsidiary.[8] The proposal would expand the definition of "control" for section 249 purposes to include indirect 80% subsidiaries that are members of a controlled group under the definition in section 1563(a)(1).[9] The proposal would be effective on the date of enactment.

## IV. International Tax Provisions

### A. Defer Interest Expenses Relating to Deferred Foreign Income

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.

The Greenbook reproposes last year's proposal that would require a taxpayer to defer its deduction of interest expense that is allocable to foreign source income and is not currently subject to U.S. tax. Any deferred deductions would be carried forward indefinitely and generally treated as current year expenses in any subsequent tax year in proportion to the amount of the previously deferred foreign source income that becomes subject to U.S. tax during that subsequent tax year. 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. The proposal would be effective beginning in 2012.

### B. Determine Foreign Tax Credits on a Pooled Basis

Under current law, a U.S. taxpayer is deemed to have paid a portion of foreign taxes paid by a 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.[10] 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,[11] with the cap applying separately to foreign source "passive" income and

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the amount of the normal call premium, unless it can demonstrate to the IRS that the excess premium amount represents an increase in the cost of borrowing, rather than an increase in the cost of the conversion feature. Section 249(a).

8 Section 249(b). For these purposes, "control" means the ownership of at least 80% of the vote and value of the corporation. Section 368(c).

9 Section 1563(a)(1) provides that one or more chains of corporations connected with a common parent corporation through 80% or more in stock ownership (by voting power or by value) are part of the same controlled group. *See* section 1563(a)(1).

10 Section 902.

11 Sections 901 and 904.

foreign source "general" income.[12] Under current law, U.S. taxpayers may selectively distribute dividends 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.

The Greenbook reproposes last year's proposal that would require a U.S. taxpayer to 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 thus would create a blended foreign tax rate with respect to a U.S. taxpayer's foreign source income (including dividend distributions from its foreign subsidiaries), and therefore is designed to prevent taxpayers from selectively repatriating high-taxed income. The proposal would be effective beginning in 2012.

### C. Limit Earnings Stripping By Expatriated Entities

Very generally, if a domestic corporation pays interest to a related foreign person, and the domestic 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 "inversion 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,[13] the Treasury Department found evidence that expatriated entities have been using earnings stripping to reduce their U.S. tax.

The Greenbook also reproposes last year's proposal to revise section 163(j) to further limit the ability of a domestic corporation to deduct interest payments made to a related expatriated entity. 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

[12] Section 904(d).

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

income. Finally, for expatriated entities, the carryforward for disallowed interest would be limited to ten years and the carryforward of excess limitation would be eliminated. The proposal would be effective beginning in 2012.

### D. Limit Shifting of Income Through Intangible Property Transfers

The Greenbook reproposes last year's proposal that would limit the shifting of income through intangible property transfers. The proposal would "clarify" the definition of intangible property for purposes of sections 367(d) and 482 to include workforce in place, goodwill, and going concern value. The proposal would also "clarify" that if multiple intangible properties are transferred, the IRS may value the intangible properties on an aggregate basis if that achieves a more reliable result. Additionally, the proposal would expressly permit the IRS to value intangible property taking into account the prices or profits that the controlled taxpayer could have realized. The proposal would be effective beginning in 2012.

## V. Tax Carried Interests as Ordinary Income

The Greenbook reproposes last year's proposal that would treat income and gain from a carried interest in a partnership that is received in exchange for services as ordinary income. In addition, the proposal would require the partner to pay self-employment taxes on such income, and gain recognized on the sale of a carried interest would generally be taxed as ordinary income, not as capital gain. However, in contrast to last year's proposal, which applied to services interests in any partnership, the proposal is limited to income from a carried interest in a partnership only if (i) 50% of the partnership's assets are investment-type assets (e.g., certain securities, real estate, partnership interests) and (ii) more than 50% of the partnership's contributed capital is from partners whose partnership interests are passive assets held for the production of income.[14]

The proposal would be effective beginning in 2012.

## VI. Treat the Gain and Loss of Dealers from Section 1256 Contracts as Ordinary Gain or Loss

The Greenbook reproposes last year's proposal that would 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-

[14] Although the scope of "held for the production of income" is unclear, it appears that if a dealer holds a partnership interest as inventory or as a hedge, the partnership interest is not being held for the production of income.

market treatment each year on their "section 1256 contracts,"[15] but the gain or loss is treated as 60% long-term and 40% short-term capital gain.[16] The Greenbook 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.

## VII. Insurance Provisions

### A. Expand Disallowance of Interest Expense Deduction for Certain Corporate-Owned Life Insurance ("COLI")

In general, taxpayers are not subject to current federal income tax with respect to the "inside buildup" of value of an insurance contract, and these earnings and any death benefits received under a life insurance or endowment contract are generally exempt from tax.[17] Similarly, individuals generally defer federal income tax on amounts received under an annuity contract. Because death benefits are exempt from tax and amounts received under an annuity are tax deferred, section 264(a) generally denies interest expense deductions on indebtedness used to purchase life insurance contracts, endowment contracts, or annuities. In addition, under section 264(f), a pro rata portion of a taxpayer's overall interest expense allocable to annuities, insurance policies, or endowments with cash surrender values is generally disallowed. However, the section 264(f) disallowance does not apply with respect to insurance contracts for individuals who are officers, directors, employees, or 20% owners of the taxpayer. As a result, taxpayers that do not directly borrow to fund premium payments with respect to life insurance, endowments, or annuity contracts with respect to officers, directors, employees, or 20% owners of the taxpayer are not denied interest expense, even though the death benefits from these policies are exempt from tax (and annuity proceeds are tax deferred) and even though the taxpayers can use the benefits and proceeds to fund their tax deductible interest expense.

The Greenbook reproposes last year's proposal to expand section 264(f) and deny a taxpayer's pro rata portion of interest expense allocable to policies with cash surrender value on individuals who are officers, directors, or employees of a taxpayer, but would retain the current law exemption for

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[15] 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. Section 1256.

[16] Section 1256.

[17] Death proceeds on policies purchased for value generally are taxable.

contracts relating to 20% owners of the holder or beneficiary of the contract. The proposal would be effective for contracts issued in or after 2012.[18]

### B. Reporting for Sales of Life Insurance Contracts

The Greenbook reproposes last year's proposal (i) to require the purchaser of an existing life insurance contract that provides for a death benefit equal to or exceeding $500,000 to report the purchase price, the buyer and seller's taxpayer identification numbers ("TIN"s), and the issuer and policy number, to the IRS, the insurance company that issued the policy, and to the seller and (ii) to require the insurance company to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee, upon the payment of any benefits to the buyer. The proposal would be effective beginning in 2012.

### C. Expansion of the Transfer-for-Value Rules for Sales of Life Insurance Contracts

Under current law, the purchaser of a policy for value ("transfer-for-value") generally does not qualify for the general tax exemption for death benefit proceeds, subject to limited exceptions in the case of a transfer involving a carryover basis or in the case of a transfer to the insured or to certain parties treated as related to the insured. The Greenbook proposes to modify the transfer-for-value rules to ensure that buyers of policies are taxable on death benefit proceeds and do not qualify for the carryover basis or related party exceptions. The proposal would be effective beginning in 2012.

### D. Limitation on the Dividends Received Deduction for Insurance Companies

The Greenbook proposes to change the proration rule used by insurance companies to determine the amount of the "dividend received deduction" to which an insurance company is entitled.[19] The proposal would be effective beginning in 2012.

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[18] For these purposes, any material increase in death benefits under a contract or other material change in a contract would be treated as a new contract. In the case of a master contract, the addition of covered lives to the contract would be treated as a new contract only with respect to the additional covered lives.

[19] The proration rule was initially addressed in Revenue Ruling 2007-54 (August 16, 2007). However, Treasury and the IRS subsequently determined that the issue would be most appropriately addressed by regulation and therefore suspended Revenue Ruling 2007-54. *See* Revenue Ruling 2007-61 (September 25, 2007).

### E. Denial of Deduction on Reinsurance Premiums Paid to a Related Foreign Person

The Greenbook reproposes last year's proposal to deny a U.S. insurance company a deduction for reinsurance premiums paid to an affiliated foreign reinsurance company with respect to U.S. risks insured by the insurance company or its U.S. affiliates. This year's proposal is broader than last year's,[20] but would permit U.S. companies that are subject to the proposal to exclude from income any ceding commissions or reinsurance recovered with respect to policies for which a reinsurance premium deduction was wholly or partially denied under the proposal (in the same proportion that the reinsurance premium deduction was denied). The proposal would be effective beginning in 2012.

## VIII. Other Provisions

- Estate Tax Valuation Consistency and Reporting Requirement. The Greenbook reproposes last year's proposal to impose a consistency and reporting requirement for estate tax valuations. The proposal would be effective as of the date of enactment.
- Repeal Non-Qualified Preferred Stock Rules. In general, the receipt of stock in exchange for (i) property, in a corporate organization or (ii) stock or securities in a reorganization pursuant to a plan of reorganization, is not taxable to the recipient. However, if in addition to receiving stock, the taxpayer receives money or property ("boot"), the taxpayer must recognize any gain on the exchange up to the value of the boot.[21] A taxpayer is not permitted to recognize a loss on the exchange, unless the taxpayer receives only boot (and no stock or securities).[22] Under current law, if a shareholder receives preferred stock and (i) the holder can require the issuer to redeem or purchase the stock, the issuer is required to redeem or purchase the stock, or the issuer has the right to redeem or purchase the stock and on the issue date is more likely than not to exercise its right or (ii) if the dividend rate on the preferred stock varies with reference to interest rates, commodity prices or other similar indices, then the stock is characterized as "non-qualified preferred stock" and treated as boot.[23] Under current law, by structuring

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20 Last year's proposal applied only if the amount of reinsurance premiums paid to the foreign reinsurer was more than 50% of the total amount of insurance premiums received by the U.S. insurance company. This year's proposal does not contain this threshold.

21 Section 351(b)(1), 356(a).

22 Section 351(b)(2), 356(c).

23 Sections 351(b) and (g) and 354(a)(2)(C).

consideration as non-qualified preferred stock, corporations that are parties to reorganizations can permit their shareholders with depreciated stock or securities to recognize losses in the reorganization. The Greenbook proposes to treat non-qualified preferred stock as stock and not as taxable boot. The proposal would be effective for stock issued in or after 2012.

- **Simplify the "Fractions Rule."** Under current law, tax-exempt organizations are generally subject to tax on income earned with respect to debt-financed property. However, certain pension funds and educational organizations (i.e., "qualified organizations") are not subject to tax under the debt-financed property rules if they incur debt to acquire or improve real property. In addition, if the qualified organization invests in real property through a partnership that has incurred indebtedness, the qualified organization is not subject to tax under the debt-financed property rules, so long as the partnership either (i) consists entirely of qualified organizations, (ii) has entirely pro rata allocations, or (iii)(1) the allocation of items to a partner that is a qualified organization cannot result in the qualified organization receiving an overall share of partnership income greater than its share of partnership losses for the year in which its loss share is the smallest and (2) each partnership allocation has "substantial economic effect." The test described in clause (iii) is referred to as the fractions rule. The Greenbook would replace the fractions rule with a rule that would require only that (i) each partnership allocation has substantial economic effect (ii) and that no allocation has a principal purpose of tax avoidance. The proposal would be effective as of the date of enactment.

- **Repeal Preferential Dividend Rule for Publicly Traded Real Estate Investment Trusts (REITS).** Under current law, REITs are allowed a dividends paid deduction only if dividends are distributed pro rata to the shareholders of each class with no preference for particular shares of stock within the same class of stock (i.e., the dividend must not be a "preferential dividend"). The Regulated Investment Company Modernization Act of 2010 repealed the analogous requirement for publicly-traded RICs. The Greenbook would also repeal the preferential dividend rule for publicly-traded REITs. The proposal would apply to distributions made in taxable years after the date of enactment.

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If you have any questions about the foregoing, please contact any member of the Cadwalader Tax Department.