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Clients&FriendsMemo

The Obama Administration's Fiscal Year 2011 Revenue Proposals

February 3, 2010

I. Introduction

On Monday, the Treasury Department released the Obama Administration's Fiscal Year 2011 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.

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

- **Increase Tax Rates and Reduce the Value of Deductions for High-Income Individuals.**
  - The Greenbook proposes a reinstatement of the tax rates that existed prior to the enactment of the Economic Growth Tax Relief Reconciliation Act of 2001. Thus, the highest individual income tax rate would increase from 35% to 39.6%, and the 33% rate would increase to 36%. The maximum rate for long-term capital gains and qualifying dividends would increase from 15% to 20%.
  - The Greenbook would also 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.
  - Finally, the Greenbook would 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 36% or 39.6% tax brackets. A similar provision would apply under the AMT.

  Each of these proposals would be effective beginning in 2011.

- **Impose a Financial Crisis Responsibility Fee on Financial Firms.** The Greenbook proposes a nondeductible "financial crisis responsibility fee" of approximately 15 basis points on certain liabilities of financial institutions with consolidated assets of $50 billion or more. The fee would apply as of July 1, 2010.

- **Tax Carried Interests as Ordinary Income.** The Greenbook reproposes the proposal from the 2009 Greenbook that would 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. The proposal would be effective beginning in 2011.

- **International Tax Provisions.** The Greenbook does not include the proposal contained in the 2009 Greenbook that would treat certain "check the box" foreign subsidiaries as foreign corporations for U.S. federal income tax purposes.

  The Greenbook does, however, repropose the 2009 proposal that would defer a U.S. taxpayer's deduction of interest expense that is allocable to untaxed foreign source income (but, in contrast to the 2009 proposal, the Greenbook would not defer other expenses allocable to untaxed foreign source income). The Greenbook also reproposes the 2009 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. In addition, the Greenbook reproposes the 2009 proposal to repeal the holding of the *Guardian Industries* case,[1] and prevent U.S. taxpayers from claiming foreign tax credits prior to the recognition of the associated foreign income, and reproposes the 2009 proposal that would limit the shifting of income through intangible property transfers. These proposals would become effective beginning in 2011.

- **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 the 2009 Greenbook 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 2012 and 2022. (The 2009 Greenbook had proposed that the difference be reported over eight taxable years.) 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 the 2009 proposal. These proposals would be effective for taxable years beginning one year after the date of their enactment.

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

- **Increased Foreign Account Reporting.** The Greenbook proposes reporting requirements similar to those proposed in the 2009 Greenbook and introduced in the Foreign Account Tax Compliance Act of 2009 ("FATCA") and the Tax Extenders Act of 2009. Under the proposal, foreign financial institutions would be required to enter into an agreement with the IRS to disclose debt, equity and certain other "account holders" or otherwise be subject to a 30% withholding tax on their U.S. source income; certain other foreign (non-financial institution) entities would be subject to similar requirements, but only with respect to 10% U.S. equityholders. In addition, the Greenbook reproposes the proposal contained in FATCA and the Tax Extenders Act that U.S. individuals who own assets in a foreign account exceeding $50,000 be required to file an annual information return that discloses information about their foreign accounts.

The balance of this memorandum is divided into eleven 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 equity swap provisions; Part VII discusses enhanced foreign reporting provisions; Part VIII discusses provisions relating to bearer bonds; Part IX discusses provisions relating to dealers; Part X discusses provisions relating to the economic substance doctrine; Part XI discusses life insurance provisions; and Part XII discusses certain other provisions.

II. Financial Crisis Responsibility Fee

The Greenbook proposes a nondeductible "financial crisis responsibility fee" of approximately 15 basis points 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 as of July 1, 2010.

III. Corporations

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

The Greenbook reproposes the 2009 Greenbook 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.[2] 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 2012.

B. Treat Boot In Excess of Gain as a Dividend.

The Greenbook reproposes the 2009 Greenbook proposal to repeal the "boot-within-gain" limitation, but in contrast to the 2009 proposal, which repealed the limitation only if boot was received from a foreign corporate acquirer, the Greenbook would repeal the limitation for boot received from domestic acquirors as well.

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.[3] The expansion of the proposal to include stock from domestic acquirors as well as from foreign acquirors increased the revenue estimate for this proposal from $297 million to $788 million over 10 years. The proposal would be effective beginning in 2011.

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2 Section 1032.

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

3 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 acquiror corporation. Section 356(a).

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

The Greenbook reproposes the 2009 Greenbook 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.[4] For this purpose, the definition of "control" includes only a parent corporation and its wholly-owned subsidiary.[5] 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).[6] The proposal would be effective on the date of enactment.

IV. International Tax Provisions

A. Absence of the "Check-the-Box" Proposal.

The 2009 Greenbook contained a proposal that would have treated 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 check-the-box proposal does not appear in the 2010 Greenbook.

B. 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 the 2009 Greenbook 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

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4 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 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).

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

6 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).

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. The proposal is similar to the 2009 Greenbook proposal, and a prior proposal introduced by Congressman Charles Rangel.[7] However, in contrast to the 2009 Greenbook proposal and the Rangel bill, which would defer all expenses relating to deferred foreign income (other than research and experimentation expenditures), the 2010 Greenbook proposal would defer only interest expense relating to deferred foreign income. This change reduces the revenue estimate from $60 billion to $25.6 billion over 10 years. Moreover, under the 2010 Greenbook proposal (and the Rangel proposal, but not the 2009 Greenbook proposal), 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.[8] The proposal would be effective beginning in 2011.

C. 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 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.[9] 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,[10] with the cap applying separately to foreign source "passive" income and foreign source "general" income.[11] 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 the 2009 Greenbook 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

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7 See Section 3201 of H.R. 3970 (2007). H.R. 3970 is referred to as the "Rangel bill."

8 The 2009 Greenbook proposal would have allowed deferred deductions as deductions in a subsequent year so long as there was sufficient foreign-source income subject to U.S. tax in that year, regardless of whether any previously deferred income was repatriated in the subsequent year.

9 Section 902.

10 Sections 901 and 904.

11 Section 904(d).

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.[12] The proposal would be effective beginning in 2011.

D. Prevent Splitting of Foreign Income and Foreign Taxes for Foreign Tax Credit Purposes.

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.[13] In *Guardian Industries*,[14] 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, the U.S. taxpayer was entitled to a foreign tax credit, but because the income was deemed to be earned by CFCs and was not Subpart F income, the U.S. taxpayer could continue to defer tax on the income earned by the foreign operating subsidiaries.

The Greenbook reproposes the 2009 Greenbook proposal and 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) until and only to the extent that they report the associated foreign income. Although the proposal is substantially the same as the 2009 Greenbook proposal, the revenue estimate for the proposal in the Greenbook is substantially greater ($27.4 billion over 10 years for the Greenbook proposal as opposed to $18.5 billion over 10 years for the 2009 proposal). We suspect that the proposal now generates more revenue because the "check the box" proposal was dropped. The proposal would be effective beginning in 2011.

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[12] The Greenbook proposal is similar to an analogous proposal in the Rangel bill, except that the Rangel bill provided that any previously deferred foreign income tax credits would be allowed in a subsequent year only in proportion to the amount of previously deferred foreign income repatriated in that year. Moreover, the Greenbook proposal clearly applies only to deemed paid (i.e., section 902) foreign tax credits, and not to direct foreign tax credits under section 901. The Rangel bill was unclear on this point.

[13] 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).

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

E. 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,[15] the Treasury Department found evidence that expatriated entities have been using earnings stripping to reduce their U.S. tax.

The Greenbook has reproposed the 2009 Greenbook 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 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. This proposal is substantially similar to a proposal in the 2009 Greenbook, except that the 2009 Greenbook proposal did not reduce the 50% adjusted taxable income threshold for interest paid to unrelated parties on debt that is subject to a related-party guarantee. The proposal would be effective beginning in 2011.

F. Limit Shifting of Income Through Intangible Property Transfers.

The Greenbook reproposes the 2009 Greenbook 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

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[15] 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.

property taking into account the prices or profits that the controlled taxpayer could have realized. The proposal would be effective beginning in 2011.

G. Repeal the 80/20 Company Rules.

The Greenbook reproposes the 2009 Greenbook proposal to repeal the "80/20 company" rules. Under current law, dividends and interest paid by a U.S. corporation to foreign persons are generally subject to gross basis withholding. A limited exception exists with respect to a domestic corporation that derives at least 80% of its gross income from the active conduct of a foreign trade or business during a three-year testing period (a so-called "80/20" company). The proposal would be effective beginning in 2011.

V. Tax Carried Interests as Ordinary Income

The Greenbook reproposes a proposal from the 2009 Greenbook 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. The proposal is identical to the 2009 Greenbook proposal, but it is broader than the proposal introduced in prior bills introduced in Congress,[16] because the Greenbook proposal would apply to a carried interest received for *any* services (not just to carried interests in partnerships that provide investment management services to investment funds). The proposal would be effective beginning in 2011.

VI. Withholding on Equity Swaps and Securities Loans

Under current law, payments of U.S. source dividends to non-U.S. persons are generally subject to a 30% withholding tax. Similarly, substitute dividend payments on securities loans, sale-repurchase agreements, and substantially similar agreements are subject to a 30% withholding tax.[17] However, dividend equivalent amounts paid to a non-U.S. person under an equity swap are generally sourced by reference to the residence of the payee and, therefore, for a foreign payee, are not subject to withholding.[18]

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[16] See H.R. 3996 (2007); H.R. 6275 (2008).

[17] 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).

[18] 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).

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.[19]

The Greenbook reproposes the 2009 Greenbook proposal that would treat dividend equivalent payments on cross-border equity swaps as subject to a 30% U.S. withholding tax unless the swap is unlikely to reflect avoidance of U.S. withholding tax. The 2009 Greenbook listed specific characteristics of a swap that are unlikely to reflect tax avoidance.[20] The Greenbook does not expressly provide a safe harbor or list relevant characteristics, but would authorize the IRS and the Treasury Department to provide such a safe harbor.

Finally, the Greenbook reproposes the 2009 Greenbook proposal to reform existing rules applicable to substitute dividends paid under securities loans in order to prevent the avoidance of dividend withholding taxes, but does not provide any details on the reform.[21]

The proposal would be effective beginning in 2011.

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[19] More specifically, under the transaction, a foreign person subject to a 30% withholding tax on dividends would loan U.S. equity securities to a second foreign person 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 Treasury 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] The 2009 Greenbook provided that a safe harbor was available for equity swaps that satisfied the following six 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 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.

See here for a brief discussion of policy questions regarding the proposal, as well as specific issues surrounding the six listed conditions.

FATCA (discussed here) provided similar characteristics for determining whether a swap has potential for tax avoidance.

[21] Although the Greenbook does not explicitly mention Notice 97-66 (as did the 2009 Greenbook), it appears that the intent of the proposal is to revoke Notice 97-66 and issue new guidance.

VII. Enhanced Foreign Reporting

A. Require Increased Reporting by Foreign Financial Institutions; Foreign Non-Financial Institutions.

The Greenbook reproposes the 2009 Greenbook proposal that a "foreign financial institution" (which is defined broadly and includes many foreign hedge funds, private equity funds, and securitization vehicles) be subject to a 30% withholding tax on its U.S. source interest, dividends and other "fixed or determinable annual or periodic" income and its gross proceeds from certain dispositions, unless it enters into an agreement with the IRS. The agreement would require a foreign financial institution to identify accounts held by U.S. persons or by foreign entities in which a U.S. person owns more than 10%, and to report to the IRS the name, address, and taxpayer identification number of the U.S. accountholders, the account balance or value, and the gross receipts and withdrawals. Similar proposals were included in FATCA and more recently in the Tax Extenders Act. The Greenbook (and FATCA and the Tax Extenders Act) contain similar requirements for foreign non-financial institutions, but only with respect to 10% equityholders.

It is unclear whether the Greenbook proposal intends to incorporate certain helpful provisions of the Tax Extenders Act. Most significantly, the Tax Extenders Act provides that, if a foreign financial institution is unable to obtain necessary information from a particular account holder (referred to as a "recalcitrant account holder"), the foreign financial institution may either (i) withhold 30% from the payments it makes to the recalcitrant account holder or (ii) elect to receive its U.S. source payments subject to 30% withholding on the portion that is allocable to the recalcitrant account holder. The Tax Extenders Act also provides that a foreign financial institution need not report any U.S. account holder if the account is held by another foreign financial institution that itself satisfies the reporting requirements under the Tax Extenders Act, or if the account holder is otherwise subject to information reporting that Treasury determines would make reporting by the foreign financial institution duplicative. Finally, the Tax Extenders Act would not apply to any payment made under any obligation that is outstanding two years after the date of enactment. These helpful provisions are not mentioned in the Greenbook.

The proposals would be effective beginning in 2013.

B. Require Disclosure of Foreign Financial Assets To Be Filed with Tax Return.

The Greenbook reproposes the 2009 Greenbook and FATCA proposals that U.S. individuals who hold an interest in a foreign financial account or foreign entity, or any financial instrument or contract held for investment that is issued by a foreign person, with a value in excess of $50,000, would be required to file an annual information return. The proposal would be effective for taxable years after the date of enactment.

C. Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets.

The Greenbook reproposes the 2009 Greenbook proposal to impose a 40% accuracy-related penalty for any understatement attributable to undisclosed foreign financial assets (in place of the 20% accuracy-related penalty imposed under current law). A similar proposal was included in both the Tax Extenders Act and FATCA. The proposal would be effective for taxable years after the date of enactment.

D. Extend Statute of Limitations for Significant Omissions of Income Attributable to Foreign Financial Assets.

The Greenbook reproposes the provision from the 2009 Greenbook that if a taxpayer omits from gross income more than $5,000 attributable to foreign financial assets for which disclosure is required, the statute of limitations would be extended from three years to six years after the required return was filed. A similar proposal was included in both the Tax Extenders Act and FATCA. The proposal would be effective for tax returns due to be filed after the date of enactment, and for returns whose statute of limitations have not expired as of the date of enactment.

VIII. Limit Ability to Issue Bearer Bonds

The Greenbook reproposes the FATCA proposal to repeal the existing exemption from U.S. withholding tax for "foreign targeted bearer bonds" and would impose a 30% withholding tax on interest paid on bearer bonds (and other bonds that are not in registered or book entry form for U.S. tax purposes) issued by U.S. issuers, unless the obligation (1) is issued by a natural person, (2) matures in one year or less, or (3) is not of a type offered to the public. Under the proposal, a debt obligation held through a "dematerialized" book entry system (such as in Japan) would be treated as issued in registered form. The provision is proposed to apply to debt obligations issued after the date that is two years after enactment. Therefore, the provision would not apply to any currently outstanding bearer bond (or bearer bonds issued for the next two years). This proposal is substantially similar to a proposal in the Tax Extenders Act.

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

The Greenbook reproposes the 2009 Greenbook 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-market treatment each year on their "section 1256 contracts,"[22] but the gain or loss is treated as 60% long-term and 40% short-term capital gain.[23] 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.

X. Codify the "Economic Substance Doctrine"

The Greenbook reproposes the 2009 Greenbook proposal that would codify the judicial "economic substance doctrine." Under the proposal, a taxpayer would be required to demonstrate that a transaction changes the taxpayer's economic position in a meaningful way (apart from federal tax effects) and that 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 analogous provision in the Rangel bill, and in the Stop Tax Havens Abuse Act (S. 506), introduced in 2009 by Senator Carl Levin (D-Michigan), 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.

XI. 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.[24] 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

[22] 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.

[23] Section 1256.

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

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 would 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 contracts relating to 20% owners of the holder or beneficiary of the contract. The proposal would be effective for contracts issued in or after 2011.[25]

XII. Other Provisions

- **Reporting for Sales of Life Insurance Contracts.** The Greenbook proposes (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 2011.
- **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 2011.
- **Limitation on the Dividends Received Deduction for Insurance Companies.** The Greenbook proposes to change the proration rule used by insurance companies to

[25] 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.

determine the amount of the "dividend received deduction" to which an insurance company is entitled.[26] The proposal would be effective beginning in 2011.

- **Denial of Deduction on Reinsurance Premiums Paid to a Related Foreign Person.** The Greenbook proposes to deny a U.S. insurance company a deduction for certain reinsurance premiums paid to affiliated foreign reinsurance companies with respect to U.S. risks insured by the insurance company or its U.S. affiliates. The proposal would be effective beginning in 2011.
- **Form 1099 Reporting on Payments to Corporations.** The Greenbook proposes to require a Form 1099 reporting for businesses that make certain payments of $600 or more to a corporation. The proposal would be effective beginning in 2011.
- **Estate Tax Valuation Consistency and Reporting Requirement.** The Greenbook proposes to impose a consistency and reporting requirement for estate tax valuations. The proposal would be effective as of the date of enactment.

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If you have any questions about the Fiscal Year 2011 Revenue Proposals, please contact any member of the Cadwalader Tax Department.

[26] 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).