White House delivers details – and surprises – in expanded FY 2010 budget package

More than two months after releasing its FY 2010 budget blueprint and a week after unveiling a set of provisions to reform the international tax rules, the Obama administration on May 11 provided a comprehensive description of its tax proposals for the coming fiscal year. This latest budget document describes more than 40 new provisions ranging from additional penalties or information reporting to dramatic new tax increases on businesses and estate tax reforms.

Overall, the new details reinforce the fundamental structure of the administration's prior statements on taxation: tax cuts for working families, tax increases for businesses and upper-income individuals, reform of international tax rules, and closing of perceived corporate loopholes.

The expanded budget package clarifies many of the provisions in the laundry list of proposals included in the budget outline the White House released in February. In some cases, however, it elaborates on these provisions in unexpected ways. The proposal to treat income from carried interests as ordinary income, for example, has been expanded to all service partnerships, not just asset management partnerships.

The detailed budget package also proposes to make a down payment on health care reform – one of President Obama's top legislative priorities for this year – through a nearly $326 billion "health reform reserve fund" of corporate and individual revenue raisers. The centerpiece of this reserve fund is the provision included in the February budget outline that would limit the rate at which itemized deductions reduce tax liability to 28 percent for single taxpayers earning over $200,000 a year and joint filers earning over $250,000.

The reserve fund also includes new proposals to:

- Modify the estate and gift tax valuation discount rules;
- Expand information reporting rules in ways that would not just track income, but also flag potential areas of taxpayer noncompliance;
- Close certain perceived corporate loopholes for financial institutions and insurance companies;
- Make "black liquor" ineligible for the alternative fuel mixture credit;
- Repeal the lower-of-cost-or market inventory accounting method; and
- Deny the deduction for punitive damages.

Unlike other business revenue raisers in the budget package, which generally would not become effective until 2011, many of the provisions in the health care reserve fund would become effective upon enactment or in 2010.

Additionally, several new international reform proposals were debuted in the May 11 release. These include provisions to limit earnings stripping by expatriated entities, prevent repatriation of earnings in certain cross-border reorganizations, repeal the 80/20 company rules, and repeal the dual-capacity rules.

Health Reform Reserve Fund

President Obama has made it clear that reforming the health care system is one of his top legislative priorities for 2009. Leaders of the House and Senate taxwriting committees have begun holding hearings on health care issues and are committed to producing legislation this summer. The president's expanded budget package includes some $326 billion in provisions to bankroll the cost of health care reform, most of which are proposed to become effective upon enactment or in 2010.

Limit tax rate at which itemized deductions can reduce tax liability

The administration continues to propose to limit the tax rate at which itemized deductions reduce tax liability, even though this proposal has found little support on Capitol Hill since it was unveiled in February. Under this proposal, taxpayers in the highest two brackets (36 and 39.6 percent) would deduct itemized expenses at the 28 percent rate. For example, under current law a taxpayer in the 35 percent bracket could receive a benefit of $350 for a $1,000 charitable contribution. If the administration's curb on the savings provided by itemized deductions were enacted, the benefit for the same contribution would be limited to $280. A similar limitation would apply under the alternative minimum tax (AMT). Opponents of the

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proposal argue that it could result in lower aggregate charitable contributions and raise the after-tax cost of financing and maintaining a residence.

While the administration originally estimated that the proposal would raise $318 billion over 10 years, that estimate has been revised downward to $267 billion over 10 years. The proposal would be effective for taxable years beginning after December 31, 2010.

Reduce the tax gap and improve compliance

The health reform reserve fund includes $10.7 billion in new revenue from provisions to shrink the "tax gap," and improve compliance, tighten information reporting, improve tax administration, and increase penalties.

Information reporting for private separate accounts of life insurance companies – The proposal would require life insurance companies to provide taxpayer identification numbers (TINs), the policy number, the balance of untaxed income accumulated, the account value, and the portion of the value that was invested in one or more private separate accounts. Information reporting would be required when the cash value of a contract is wholly or partially invested in a private separate account during the taxable year. The provision would be effective for taxable years beginning after December 31, 2010, and would raise $20 million over 10 years.

Information reporting on payments to corporations – The proposal would modify existing rules regarding reporting of payments made to corporations. It would require a business to file a Form 1099 to report payments made to a corporation totaling $600 or more in a calendar year. Notably, this provision was included in the Bush administration's FY 2008 and FY 2009 budgets, but was not enacted. The provision would be effective for payments made after December 31, 2009, and would raise an estimated $9.15 billion over 10 years.

Information reporting and withholding for contractors – The provision would require a contractor receiving $600 or more from a business to provide a Form W-9 with the contractor's TIN. The business would be responsible for verifying the TIN information with the Internal Revenue Service, which would validate the TIN. Should the contractor fail to provide the appropriate information, the business would be directed to withhold a percentage of gross payments. The flat-rate withholding could be at a rate of 15, 20, 30, or 35 percent, to be selected by the contractor. The proposal would raise $704 million over 10 years, effective for payments to contractors after December 31, 2009.

Information reporting on government contracts – The Treasury and IRS would be directed to provide regulations requiring information reporting on non-wage payments made by federal, state, or local governments to purchase property or services. Certain types of payments could be excluded from this requirement, including payments of interest, payments for real property, payments to tax-exempt entities or foreign governments, intergovernmental payments, and payments under a classified or confidential contract. The proposal would raise $191 million over 10 years, effective for payments made after December 31, 2009.

Increased information return penalties – This proposal would increase information return penalties for failure to disclose certain information to the IRS. The first-tier penalty would increase from a current-law $15 to $30 per return, and the maximum penalty for a calendar year would increase from $75,000 to $250,000. The second-tier penalty would increase from $30 to $60 per return, and the maximum would increase from $150,000 to $500,000. The third-tier penalty would increase from $50 to $100, while the maximum would increase from $250,000 to $1,500,000. Small filers would see an increase in the calendar-year maximum from $25,000 to $75,000 for first-tier, $50,000 to $200,000 for second-tier, and $100,000 to $500,000 for third-tier penalties. The penalty minimum for intentional disregard would increase from $100 to $250 for each failure. The penalties would be adjusted for inflation every five years. The proposal would raise $376 million over 10 years.

Require e-filing by certain large organizations – The administration proposes to require those corporations who file a Schedule M-3 to file returns electronically. For those large taxpayers who do not file the Schedule M-3, regulations would be expanded to allow reduction of the current threshold of filing 250 or more returns in a calendar year. A waiver request would be allowable by any taxpayer that does not possess adequate technology to meet the e-filing requirements, that would be unduly burdened by the requirement, or if other requirements in the regulations are met. The proposal would be effective for tax years ending after December 31, 2009 and is estimated to have no revenue impact.

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Liability for employee leasing companies – The proposal would set standards for holding employee leasing companies jointly and severally liable with their clients for federal employment taxes. The proposal would raise $57 million over 10 years, effective for wages paid after December 31, 2009.

Tax administration

The administration's budget also proposes a series of provisions to strengthen tax administration. The eight provisions would raise $175 million over 10 years.

Expand required electronic filing by return preparers – The provision would require return preparers who file more than 100 returns per year to file electronically. Current regulations provide that the return preparer must use electronic filing if they file at least 250 returns. The proposal would be effective for returns filed after December 31, 2010.

Other tax administration provisions – The budget proposal also would:

- Allow the IRS and Treasury to assess court-ordered restitution as tax, effective after December 31, 2010;
- Eliminate requirements that an initial offer-in-compromise include a nonrefundable payment of any portion of the taxpayer's offer, effective for offers submitted after the date of enactment;
- Expand IRS access to information in the National Directory of New Hires for tax administrative purposes, effective on the date of enactment;
- Make repeated willful failure to file a tax return a felony, effective for returns required to be filed after December 31, 2009;
- Treat Indian tribal governments that impose alcohol, tobacco, fuel excise, income, or wage taxes as states for information-sharing purposes, and require Indian tribal governments that receive federal tax return information to safeguard it according to prescribed protocols, effective for disclosures made after enactment;
- Extend the statute of limitations where state adjustment affects federal tax liability, effective for returns required to be filed after December 31, 2009; and
- Clarify taxpayer privacy law by stating that it does not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and the subject of an investigation when contacting third parties in connection with a civil or criminal tax investigation, effective for disclosures made after the date of enactment.

Expand penalties – The administration would expand the bad check penalty to cover all commercially acceptable payment instruments tendered to satisfy a tax liability, effective after December 31, 2009. A penalty would also be established for failures to comply with electronic return requirements. The penalty would be $25,000 for a corporation or $5,000 for a tax-exempt organization. The existing penalty for failure to file in any format would remain, and the proposed penalty would not apply concurrently. The provision is effective for returns filed after December 31, 2009. The two provisions would raise $36 million over 10 years.

Loophole closers

The reserve fund also includes several information reporting and "loophole closing" measures affecting the financial services and insurance industries.

Financial institutions – Three provisions would affect financial institutions and financial instruments, and they would raise about $4.1 billion by 2019.

- Forward stock sales – Currently, a company must recognize interest income on the current sale of its own stock for a deferred payment. However, a company does not recognize interest income on the forward sale of its own stock – the future issue of stock in exchange for a future payment. The administration sees no economic difference between the two situations and would align their tax treatment by requiring a corporation that enters into a forward contract to issue its stock to treat a portion of the payment as interest. The proposal would be effective for forward contracts entered into after December 31, 2010.
- Ordinary treatment for dealers – Current law allows commodities dealers, commodities derivatives dealers, dealers in securities, and options dealers to treat the income from certain day-to-day dealer activities as capital gain, and treat 60 percent of this income (or loss) as long-term capital gain and 40 percent as short-term capital

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gain. The administration proposes ending this treatment altogether and taxing dealers' income from day-to-day dealing activities at ordinary rates. This is similar to a proposal made by the Clinton administration. The proposal would be effective for taxable years beginning after the date of enactment.

- Control – If a company repurchases a debt instrument that is convertible into its stock or into the stock of a corporation it controls or is controlled by, current law may disallow or limit the issuer's deduction for the premium paid to repurchase the instrument. To determine control, section 249 references the control test of section 368(c). The administration says this rule applies only to direct relationships such as a parent and a wholly owned, first-tier subsidiary and is unnecessarily restrictive. Instead, the administration proposes that the definition of control in section 249(b)(2) be amended to reference section 1563(a)(1), which the administration says would incorporate indirect control relationships, such as a parent and a second-tier subsidiary. This proposal would be effective on the date of enactment.

Insurance companies – The health care fund revenue raisers also include several provisions that would affect insurance companies. These proposals would raise almost $13 billion by 2019.

- Sales of life insurance contracts – The administration proposes new information reporting on life insurance settlement transactions – where the insured sells a previously issued policy to investors – because it is concerned about compliance issues raised by these transactions. The administration is also concerned that current-law exceptions to the transfer-for-value rule may give buyers of life policies the ability to structure a transaction to avoid paying tax when the insured dies. The administration proposal would require anyone who purchases an interest in an existing life insurance contract with a death benefit of $1 million or more to report the purchase price, the buyer's and the seller's TINs, and the issuer and policy number to the IRS, to the insurance company that issued the contract, and to the seller. The proposal would also require that on the payment of any policy benefits to the buyer, the insurance company would be required to report the benefit payment, the buyer's TIN, and the insurer's estimate of the buyer's basis to the IRS and to the payee. The proposal would apply to the sale or assignment of interests in life insurance policies and the payment of death benefits beginning in 2011.
- DRD for separate accounts – Current law limits the dividends received deduction (DRD) for dividends received from other domestic corporations by life insurance companies. The DRD is limited to the company's share of the dividends received (versus the share that funds reserves for obligations to policyholders) based on a proration formula. For separate accounts, the company's share and the policyholders' share is calculated separately for each separate account. The administration believes that current proration methods used by some taxpayers may inappropriately inflate the company's share for income earned by its separate account assets. The administration proposes changing the proration method to one that it says would produce the company's share of a separate account "that approximates the ratio of the mean of the surplus attributable to the account to the mean of the account's assets." This proposal would be effective beginning in 2011.
- COLI – Section 264(f) disallows deductions for portions of a business taxpayer's interest that is allocable to "unborrowed cash policy values" of corporate-owned life insurance (COLI), but there is an exception for policies covering the lives of certain employees, officers, directors, and owners. The administration believes this exception allows companies to engage in tax arbitrage and proposes to repeal the exception for employees, officers, and directors, other than 20-percent owners of a business that is the owner or beneficiary of the policy. The proposal would apply to contracts entered into after the date of enactment.

Tax accounting methods – The administration also proposes two changes to tax accounting rules that are estimated to raise almost $6.5 billion by 2019.

- Punitive damages – The administration believes the deductibility of punitive damages undermines their role in discouraging and penalizing undesirable actions, and this proposal would disallow all deductions for punitive damages paid or incurred by a taxpayer on judgment or by settlement of a claim. The proposal would also extend to punitive damages covered by insurance. The damages paid or incurred by the insurer would be included in the insured's gross income, and the insurer would be required to report the payment to the insured and the IRS. The proposal would apply to punitive damages paid or incurred after December 31, 2010.
- Lower-of-cost-or-market accounting – Current law allows certain taxpayers to write down the carrying value of their inventory under the lower-of-cost-or-market (LCM) or under the subnormal goods method by writing down the cost of goods that are unsalable at normal prices or unusable because of damage, imperfection, or similar causes. The Clinton administration proposed ending these accounting methods, and the Obama administration would prohibit them as well. The proposal would be effective for taxable years beginning 12 months after the date

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of enactment. The proposal would be a change of accounting method, and resulting section 481 adjustments would be included in income ratably over the four-year period beginning in the year of the change.

Estate and gift tax changes

The White House also would fund health care reform by closing perceived loopholes in the area of estate and gift taxation. These proposals would require consistent valuation for transfer and income tax purposes, modify rules on valuation discounts, and require a minimum term for grantor retained annuity trusts (GRATs).

Consistency in value – The Obama budget would require consistent valuation of assets transferred at death or by gift during life. The basis of property acquired from a decedent under section 1014 would have to equal the value of the property for estate tax purposes. The basis of property received by gift during the life of the donor would have to equal the donor's basis determined under section 1015. In other words, the basis of the property in the hands of the recipient would be no greater than the value of that property as determined for estate and gift tax purposes. A reporting requirement would also be imposed in which necessary information would be provided to the IRS.

Valuation discounts for property transfers – Recognizing that an array of judicial decisions and new state statutes have weakened restrictions for valuing transferred interests under section 2704(b), the administration has proposed disregarding certain temporary limits that are placed on certain transfers. The "disregarded restrictions" would include: (1) limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations; and (2) any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. The proposal would make conforming clarifications with respect to the interaction of this proposal with the transfer tax marital and charitable deductions.

The changes would be significantly narrower than a proposal sponsored by House Ways and Means Committee member Earl Pomeroy, D-N.D., who has in the past proposed limiting the use of minority discounts for transfers of family limited partnership interests. Congress could rely more heavily on the Pomeroy proposal for reforming estate taxes as the budget process moves forward.

The Obama budget proposal would apply to transfers after the date of enactment of property subject to the restrictions created after October 8, 1990 (the effective date of section 2704).

Minimum term for GRATs – Targeting a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, the proposal requires that a GRAT have a minimum term of ten years, instead of a more typical term of two years. The longer life would increase the chance that the grantor's death occurs during that term period, resulting in the inclusion of the GRAT assets in the grantor's estate versus being transferred to the beneficiaries of the GRAT if the grantor dies after the term. The change would make a significant impact on the ability to use GRATs for generation-skipping transfer tax planning. The proposal would apply to trusts created after the date of enactment.

The estate and gift tax changes would raise an estimated $24 billion over 10 years, beginning in 2010.

Limit the alternative fuel mixture credit

The administration proposes to make black liquor mixtures used as fuel in paper processing ineligible for the alternative fuel mixture credit. Black liquor is a liquid byproduct of a method used to produce wood pulp in the paper industry. Under the administration's proposal, companies that use a mixture of black liquor and diesel fuel to produce energy in their mills would no longer be able to claim a credit. The change would be effective after the date of enactment.

International Tax Reform

The administration has proposed substantial changes to the U.S. international tax regime that, if enacted as proposed, would expand the reach of the federal tax code and raise the cost of doing business in the United States. These proposals generally would become effective in 2011 and would raise some $210 billion over 10 years, according to Treasury Department estimates.

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Although international tax reform was merely a placeholder in the February budget outline, the administration released details on four specific proposals on May 4. The expanded budget package includes several additional proposals.

The administration has indicated that a portion of the revenue generated from these proposals – approximately $75 billion over 10 years – would be used to pay for a permanent extension of the research and experimentation (R&E) credit.

Business entity classification rules

The administration's proposal would reform the business entity classification ("check-the-box") rules for foreign entities. These rules allow a foreign business entity with a single owner to elect treatment as a corporation or as a "disregarded entity" for U.S. tax purposes.

Under the proposal, a disregarded entity election would be available only if the foreign entity has an owner that is not disregarded for U.S. tax purposes. Further, the owner must be organized under the laws of the same foreign country as the foreign entity is organized. The proposal specifically would not apply to a first-tier foreign entity wholly owned by a United States person, unless U.S. tax avoidance is involved.

Specifics about the tax treatment of a conversion by a foreign disregarded entity to a corporation are not set forth in the proposal. Reference is only made to following Treasury regulations and relevant tax principles. These proposed changes would, in effect, overturn "check-the-box" regulations issued during the Clinton administration that were intended to simplify and add certainty to the complex challenge of classifying entity form under foreign laws for U.S. tax law purposes.

The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise $86.5 billion from 2011-2019.

Deferral

Giving more detail on a provision that was first announced last week, the administration intends restrict the ability of companies to take current U.S. deductions for expenses – such as interest or general and administrative costs – associated with foreign income until that income is repatriated. This is similar to legislation (H.R. 3970) introduced in October 2007 by Ways and Means Committee Chairman Charles Rangel, D-N.Y., as part of his tax reform plan. However, the administration's proposal would exempt R&E expenses.

Under the administration's proposal, taxpayers would defer deductions for expenses that are allocated and apportioned to foreign-source income to the extent the foreign income is not currently subject to U.S. tax. According to the Treasury explanation, the allocation and apportionment of expenses to foreign-source income would be determined under current regulations.

Because interest expenses could make up a large portion of deferred deductions, the proposal could have a significant impact on capital-intensive or highly leveraged industries, such as construction, heavy manufacturing, and financial services.

The administration's proposal would be effective beginning in 2011 and is estimated to raise about $60 billion from 2011-2019.

Foreign tax credits

The administration has also provided more detail on its proposal to modify the foreign tax credit rules, and has divided it into two parts – one dealing with deemed paid foreign tax credits and the other creating a matching rule.

Claiming that the reduction in tax credit baskets to two has enhanced taxpayers' ability to reduce U.S. taxes on foreign-source income through cross-crediting, the administration proposes requiring taxpayers to determine their deemed-paid foreign tax credits on a consolidated basis. The taxpayer would have to calculate aggregate foreign taxes and earnings and profits of all foreign subsidiaries (including lower-tier subsidiaries) for which the taxpayer can claim a deemed foreign tax credit, and the deemed foreign tax credit would then be calculated on the basis of the amount of the consolidated earnings and profits of the foreign subs that is repatriated to the taxpayer in the current taxable year.

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The administration also claims that current law allows taxpayers to inappropriately separate "creditable foreign taxes from the associated foreign income in certain cases such as those involving hybrid arrangements." In response, the administration proposes the adoption of a matching rule that would prevent the separation of foreign taxes from associated income. However, the administration gives no further detail.

The two tax credit components would be effective in 2011 and would raise an estimated $43 billion from 2011-2019.

Intangible property transfers

The administration has proposed to clarify the definition of intangible property for purposes of the rules regarding transfers of intangibles by a U.S. person to a foreign corporation under section 367(d) and the allocation of income and deductions among taxpayers under section 482. The administration maintains that this is necessary because controversies often arise about the value of intangible property transferred between related persons and the rules applying to transfers of intangible property to foreign persons are misused.

Under the proposal, intangible property would include workforce in place, goodwill, and going concern value. For transfers of multiple intangible properties, the commissioner would have the option of valuing the intangible properties on an aggregate basis to achieve a more reliable result. The proposal also provides that the intangible property must be valued at its highest and best use, as it would between a willing buyer and seller.

The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise $2.9 billion from 2011-2019.

Earnings stripping

In November 2007, Treasury issued a report stating that it found strong evidence of earnings stripping by inverted companies, and the administration cites that study as the reason for its proposal to tighten section 163(j) and limit the deductibility of interest paid by "expatriated entities" to related persons. The George W. Bush administration also proposed to tighten these rules, and the Obama administration makes a similar proposal.

Expatriated entities would be defined by applying section 7874 and its regulations as if they were in effect beginning July 10, 1989, but the definition would not include surrogate foreign corporations that are treated as domestic companies under section 7874. For expatriated entities, the current debt-to-equity safe harbor would be eliminated, and the 50 percent adjusted taxable income threshold for the limitation would be reduced to 25 percent of adjusted taxable income for disqualified interest other than interest paid to unrelated parties on debt subject to a related-party guarantee. The proposal would allow the 50 percent adjusted taxable income threshold to continue for interest on guaranteed debt. The carryforward for disallowed interest would be limited to 10 years, and the carryforward of excess limitation would be eliminated.

The proposal would be effective beginning in 2011 and would raise $1.2 billion by 2019.

Repatriation of earnings in certain cross-border reorganizations

The administration would repeal a limitation on the recognition of gain for certain corporate reorganizations under section 356(a)(1). If a shareholder in a reorganization receives in exchange for its stock of the target corporation both stock and property that cannot be received without the recognition of gain (so-called "boot"), the exchanging shareholder is required to recognize gain equal to the lesser of the gain realized in the exchange or the amount of boot received (so-called "boot within gain" limitation).

The administration's proposal is aimed at cross-border reorganizations, and in their view, the "boot-within-gain" limitation permits U.S. shareholders to repatriate previously untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences. The proposal would repeal this limitation in reorganization transactions in which the acquiring corporation is foreign and the shareholder's exchange has the effect of the distribution of a dividend, within the meaning of section 356(a)(2).

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The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise $297 million from 2011-2019.

"80/20 company" rules

Dividends and interest paid by a domestic corporation are generally considered U.S.-source income and subject to withholding tax if paid to a foreign person. An exception to this rule applies when a domestic corporation derives at least 80 percent of its gross income from an active foreign business (an "80/20 company").

In that context, the dividends and interest paid by the 80/20 company are treated as foreign-source, and not subject to U.S. withholding tax. The administration believes that the 80/20 company provisions are subject to manipulation and has proposed their repeal.

The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise $1.2 billion from 2011-2019.

Equity swaps

The administration says that foreign portfolio investors are using equity swaps to receive the economic benefit of U.S. stock without being subject to the 30 percent withholding tax on nonresident U.S. taxpayers for fixed or determinable annual or periodic (FDAP) income from U.S. sources. The administration therefore proposes income earned by foreign persons on equity swaps that reference U.S. stock would be treated as U.S.-source to the extent that income is attributed to or calculated by reference to dividends paid by a domestic corporation. This is similar to a provision in legislation (S. 506 and H.R. 1265) introduced in March by Senate Permanent Subcommittee on Investigations Chairman Carl Levin, D-Mich., and House Ways and Means Committee member Lloyd Doggett, D-Texas.

The administration's proposal would exempt swaps that:

- Do not require the foreign person to post more than 20 percent of the underlying stock's value as collateral;
- Do not include any provision addressing the hedge position of the counterparty;
- Use underlying stock that is publicly traded and the notional amount of the swap represents less than 5 percent of the total public float of that class of stock and less than 20 percent of the 30-day average daily trading volume;
- The foreign person does not sell the stock to the counterparty at the inception of the contract or buy the stock from the counterparty at the contract's termination;
- Use objectively measurable prices to value the equity to measure the parties' entitlements or obligations; and
- Have a term of less than 90 days.

The proposal also notes that Treasury plans to revoke Notice 97-66 and "issue guidance that eliminates the benefits of such transactions but minimizes over-withholding."

The proposal would apply to payments made after December 31, 2010, and it is estimated to raise $1.4 billion by 2019.

Tax rules for dual-capacity taxpayers

Taxpayers that are subject to a foreign levy and also receive a specific economic benefit from the levying country (so-called "dual-capacity" taxpayers) may not claim a foreign tax credit for the portion of the foreign levy paid for the specific economic benefit. Under Treasury regulations, if a foreign country has a generally imposed income tax, then a dual-capacity taxpayer may credit the portion of the levy in the amount of what the generally imposed income tax would be.

The Treasury regulations also include a safe harbor if the foreign country does not generally impose an income tax. The administration is especially concerned about achieving a proper determination of the foreign tax credit where a country imposes a levy on oil and gas income only, and does not have a generally imposed income tax.

With regard to dual-capacity taxpayers, the administration's proposal would treat a foreign levy that would otherwise qualify as an income tax (or in lieu of tax) as a creditable tax only if the foreign country generally imposes an income tax. Additionally, the income tax should have substantial application to nationals or residents (not just dual-capacity taxpayers),

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with trade or business income in that country. This proposal would replace the regulatory foreign tax credit safe harbor that applies when a foreign country does not generally impose an income tax.

Further, the proposal would retain the rule of present law where the foreign country does generally impose an income tax. Note that the proposal would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. Lastly, the proposal would yield to U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

The proposal would be effective for taxable years beginning after December 31, 2010, and is estimated to raise $4.4 billion from 2011-2019.

Underreporting of income through use of accounts in offshore jurisdictions

The administration has proposed a series of measures targeted at enhancing information reporting, increasing tax withholding, and strengthening penalties to curb offshore tax evasion. These provisions would raise $8.7 billion over 10 years. The proposals generally would be effective beginning after December 31 of the year of enactment.

Qualified Intermediary program – Most notably, the administration would strengthen the Qualified Intermediary (QI) system, under which financial institutions sign an agreement to share information about their U.S. customers with the IRS.

Under the proposal, for a foreign financial institution to qualify as a QI, it must identify all of its account holders that are U.S. persons. The QI would be treated as a U.S. payor and be required to report all payments received on behalf of all U.S. account holders. Thus, QIs would file Form 1099s with respect to payments to those U.S. account holders, as though the QI were a U.S. financial institution.

To protect the integrity of the QI system, the Treasury Department would be given authority to issue regulations requiring that a financial institution may be a QI only if all commonly controlled financial institutions are also QIs. Also, the proposal would clarify that under section 6103, the IRS may publish a list of QIs.

Withholding on payments of FDAP income made through nonqualified intermediaries – The proposal would require any withholding agent making a payment of U.S.-source fixed or determinable annual or periodical gains, profits or income to a nonqualified intermediary to treat the payment as made to a foreign person. Tax would be withheld at a 30 percent rate.

The Treasury Department would be given authority to provide exceptions, including for payments collected by nonqualified intermediaries for foreign government, central bank, foreign pension fund and foreign insurance company payees, and for payments that present a low risk of tax evasion. Foreign persons would have to come forward and apply for a refund of any excess tax withheld.

Withholding on gross proceeds paid to nonqualified intermediaries – A withholding agent would be required to withhold tax at a rate of 20 percent on gross proceeds from the sale of securities that would be reported to a U.S. non-exempt payee. Payments by a withholding agent to a nonqualified intermediary that is located in a jurisdiction with which the United States does not have a comprehensive income tax treaty that includes a satisfactory exchange of information program would be covered under the proposal. The Treasury Department would be given regulatory authority to provide exceptions, similar to the FDAP provision above.

Transfers of money or property to foreign financial accounts – The proposal would require a U.S. individual to report on the individual's income tax return any transfer of money or property to foreign financial accounts. Transfers to accounts held at qualified intermediaries and receipts from accounts held by U.S. persons at qualified intermediaries would not be required to be reported.

In addition, individuals would be exempt from this reporting requirement if the cumulative amount or value of transfers/receipts reportable on the individual's income tax return for a given year were each less than $10,000. Failure to report a covered transfer would generally result in the imposition of a penalty equal to the lesser of $10,000 per reportable transfer or 10 percent of the unreported covered transfers. No penalty would be imposed for a failure to report due to reasonable cause.

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The Treasury Department would be given regulatory authority to issue rules to prevent abuse of the reporting exemptions and to provide exceptions to the reporting requirement, such as an exception for arm's-length payments in the ordinary course of business for services or tangible property.

Require disclosure of foreign bank accounts – The proposal would require individual taxpayers to file a Foreign Bank Account Report (FBAR) and disclose certain information on a schedule that would be part of their income tax returns. Information to be provided would include the account number, financial institution, and maximum value during the year. Penalties would be strengthened for any failure to file the FBAR.

Third-party information reporting – Financial institutions would face additional reporting requirements for transactions that establish a foreign business entity or transfer assets to and from foreign financial accounts on behalf of U.S. individuals. Further, reporting requirements on international investors and financial institutions would be increased, especially for QIs. A key component of the proposal would be to require QIs to report information on their U.S. customers to the same extent as U.S. financial intermediaries do.

These proposals are very similar to ones made recently by Senate Finance Committee Chairman Max Baucus, D-Mont., Senate Permanent Subcommittee on Investigations Chairman Levin, and House Ways and Means Committee member Doggett.

Foreign accounts with respect to which an FBAR has not been filed – The proposal would establish a rebuttable presumption that any financial account held by a U.S. citizen at a financial institution that is not a QI contains enough funds to require the filing of an FBAR. An exception would apply for accounts held through a QI, and the Treasury Department would be given regulatory authority to provide additional exceptions.

Penalties would be strengthened and any failure to file the FBAR would be considered willful when an account at a nonqualified intermediary has a balance greater than $200,000. The rebuttable presumption provision is apparently modeled after recent legislation (S. 506) proposed by Sen. Levin. The proposals would be effective for FBARs to be filed beginning after the date of enactment.

Double accuracy-related penalties, extend statute of limitations – The proposal would double penalties when a taxpayer fails to disclose foreign financial accounts, improve the foreign trust reporting penalty, and extend the statute of limitations from three to six years for tax returns that should have reported international transactions.

Anti-tax haven legislation – Although it offered no specific proposals, the administration indicated that it would work with congressional leaders to develop bipartisan anti-tax haven legislation in the coming months.

Business Tax Increases

Carried interests

The budget includes a proposal to tax carried interests as ordinary income. In addition, the partner receiving a carried interest would be required to pay self-employment taxes on that income, and gain recognized on the sale of such an interest would be taxed as ordinary income.

The proposal refers to "services partnership interests" (SPIs), which it defines as "a carried interest held by a person who provides services to the partnership." The proposal would not recharacterize gain to the extent that the partner who holds an SPI contributes "invested capital" and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest. Nor would the proposal recharacterize the portion of any gain recognized on the sale of an SPI that is attributable to the invested capital. The proposal defines "invested capital" as money or other property contributed to the partnership; it excludes any contributed capital that is attributable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership.

The proposal would provide relief for real estate investment trusts (REITs), stating that it "is not intended to adversely impact qualification" of a REIT owning a carried interest in a real estate partnership. It would become effective in 2011 and is estimated to raise $23.5 billion through 2019.

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Repeal LIFO

Taxpayers would not be allowed to use the LIFO inventory accounting method for federal income tax purposes. Taxpayers that currently use the LIFO method would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. That one-time increase in gross income would be taken into account ratably over the first eight taxable years. The proposal would raise $61 billion over 10 years.

Economic substance

The House and Senate have attempted several times in recent years to codify the economic substance doctrine, but the legislation has never been enacted.

The proposal would clarify that a transaction satisfies the economic substance doctrine only if (1) it changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. A transaction would not be treated as having economic substance solely by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction.

The proposal would impose a 30 percent penalty on an understatement of tax attributable to a transaction that lacks economic substance (20 percent if there is adequate disclosure on the taxpayer's return). This penalty would be in lieu of – not in addition to – other accuracy-related penalties that might be levied with respect to a tax understatement. The proposal does not specify whether the penalty would be a "strict liability" penalty or whether the penalty could be avoided as a result of good faith. It would allow the IRS to assert the penalty without any court determination that the economic substance doctrine was relevant, and it would allow the IRS to abate the penalty in proportion to the abatement of the underlying tax liability.

Finally, the proposal would deny any deduction for interest attributable to an understatement of tax arising from the application of the economic substance doctrine. The proposal would apply to transactions entered into after the date of enactment, and would raise $4.7 billion over 10 years.

Rental payments

Recipients of real estate rental income that make payments of $600 or more to a service provider (such as a plumber or accountant) in the course of earning rental income would be required to send an information return (generally, Form 1099-MISC) to the IRS and to the service provider. Exceptions would be made for particularly burdensome situations, such as for taxpayers (including members of the military) who rent their principal residence on a temporary basis, or for those who receive only small amounts of rental income. The proposal would be effective for tax years beginning after December 31, 2009, and would raise about $3 billion through 2019.

Business Tax Relief

Permanent research credit

During his campaign, Obama pledged to make permanent the research and experimentation credit, which has been repeatedly extended. This budget proposal would permanently extend the credit, at a cost of about $74.5 billion over 10 years.

Extended NOL carryback

In the negotiations over the American Recovery and Reinvestment Act of 2009 (ARRA), the president supported temporarily extending the carryback for net operating losses (NOLs) from two to five years, but the enacted legislation limited the extended carryback to small businesses for losses incurred in a tax year beginning or ending in 2008. The budget conveys the president's desire to work with Congress to expand the NOL carryback. Thus, there still are no details on the length of the carryback, the tax years to which the provision would apply, or what businesses would qualify.

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However, the revenue estimates – the provision would cost the government $28 billion in fiscal 2009 and $36 billion in fiscal 2010 – suggest that the expansion would apply to all businesses and that the carrybacks would be from 2008 and 2009.

Small-business capital gains

Last fall, Obama also promised to eliminate all capital gains taxes on start-ups and small businesses. Under current law, taxpayers other than corporations may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The exclusion is increased to 75 percent for stock acquired after February 17, 2009, and in 2010. The taxable portion of the gain is taxed at a maximum rate of 28 percent, and a portion of the excluded gain is a tax preference subject to the AMT.

To further "encourage and reward new investment in qualified small business stock," the proposal would increase the percentage exclusion to 100 percent and eliminate the AMT preference item for gain excluded under this provision. A five-year holding period and other provisions applying to the section 1202 exclusion would also apply, and the proposal would impose additional documentation requirements to assure compliance.

The proposal would be effective for qualified small business stock issued after February 17, 2009. It is estimated to cost about $5.8 billion over the 2010-2019 budget window.

Business Tax Extenders

The administration's budget proposes to extend certain business tax extenders for one year, through 2010. The proposal lacks detail on each provision, but proposes to extend current law on the following provisions:

- State and local sales tax deduction;
- Subpart F "active financing" and "look-through" exceptions;
- New Markets Tax Credit;
- Modified recovery period for leasehold improvements and qualified restaurant property;
- Exclusion from unrelated business income of certain payments to controlling exempt organizations; and
- Incentives for empowerment and community renewal zones.

Notably, the administration did not include a full list of expiring provisions. It is unclear whether a more comprehensive list will be revealed in the coming months. The administration estimates the one-year extension will cost $17.2 billion over 10 years.

Energy Provisions

The budget proposal contains revenue-raising measures that will have a substantial impact on the oil and gas industry. Together, they generate more than $31 billion in revenue over 10 years. In addition to imposing new taxes, the administration is also seeking to repeal tax preferences that promote oil and gas production, arguing that: (1) they distort markets by encouraging more investment in the oil and gas industry than would otherwise occur; (2) to the extent that they result in the overproduction of oil and gas, preferences are detrimental to long-term energy security; (3) preferences are inconsistent with the administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources; and (4) because they ultimately are financed with taxes, preferences result in underinvestment in areas of the economy that potentially are more productive.

Reinstate superfund taxes

The administration proposes to raise $17 billion over 10 years by reinstating taxes that were originally enacted in 1980 to finance the cost of cleaning up toxic waste sites and allowed to expire. The superfund taxes included: (1) an excise tax of 9.7 cents per barrel on crude oil received at a U.S. refinery and on each barrel of imported petroleum products; (2) an excise tax of varying amounts on certain hazardous chemicals sold in the U.S. or used in substances imported into the U.S.; and (3) an environmental tax of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded $2 million. These taxes would be reinstated for tax years beginning in 2011.

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Tax outer continental shelf (OCS) oil and gas production

The administration states that it is developing a proposal to impose an excise tax on OCS oil and gas in the future. Although no specifics were provided, similar proposals in Congress, such as the Energy Independence and Investment Act of 2008 that was introduced last year by Senate Finance Chairman Baucus, have called for a 13 percent excise tax on OCS oil and gas production in the Gulf of Mexico. Most major integrated oil companies and large independent oil companies will be impacted by a tax on OCS production and if the amount of U.S. tax exceeds similar taxes imposed by other countries, foreign exploration may be more feasible for some companies.

Repeal the section 199 deduction for oil and gas companies

House and Senate taxwriting committees have sought in prior years to eliminate this deduction for large integrated oil companies. Congress took a different approach in last year's Emergency Economic Stabilization Act, opting to freeze the deduction at 6 percent for all oil and gas companies. The administration's proposal would fully repeal the deduction for these companies.

Repeal the passive loss exception for working interests in oil and gas companies

Under current law, the passive activity loss rules, which limit the ability of taxpayers to deduct certain losses, are not applicable to working interests in oil or gas property that a taxpayer holds directly or indirectly through an entity that does not limit the taxpayer's liability with respect to the interest. Repealing this exclusion would make it more difficult for small and medium-sized companies to attract investors and to obtain the capital needed to fund exploration projects.

Repeal incentives for exploration

A number of the current tax incentives for domestic exploration and drilling would be eliminated. These include:

- 24-month amortization for geological and geophysical costs for independent oil and gas producers;
- The enhanced oil recovery credit;
- The marginal well tax credit;
- The deduction for tertiary injectants;
- Expensing of intangible drilling costs (IDCs) and 60-month amortization of capitalized IDCs; and
- Percentage depletion for oil and gas wells.

Limit the alternative fuel mixture credit

The administration includes a proposal in its health reform reserve fund to make black liquor mixtures used as fuel in paper processing ineligible for the alternative fuel mixture credit. (See discussion above.)

Individual Income Tax Provisions

President Obama's latest budget holds few surprises in the individual income tax area, largely recommending to make permanent tax relief provisions that were included in the American Recovery and Reinvestment Act, while over the long term calling for a shift of the tax burden from low- and middle-income taxpayers to high-income taxpayers.

Budget assumptions

First, the White House has built several significant assumptions related to individual tax rates into its budget baseline. Specifically, the budget assumes that:

- The 2001 and 2003 Bush tax cuts will be extended for lower-and middle-income taxpayers;
- The estate tax will be frozen at 2009 levels – that is, an exemption of $3.5 million ($7 million for married couples) and a top rate of up to 45 percent; and
- The increased individual AMT exemption amounts for 2009 that were enacted in the ARRA – $46,700 (for individuals) and $70,950 (married filing jointly) – will be indexed for inflation going forward, and the ability to use nonrefundable credits against the AMT will be extended.

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Tax increases, deduction limitations for high-income earners

Second, Obama's budget outline delivers on several of his campaign promises to increase income taxes on higher-income individuals, including:

- Reinstating the top two individual income tax rates, currently 33 and 35 percent, at their pre-2001 levels – 36 and 39.6 percent – beginning in 2011. The 36 percent bracket would begin at taxable income of $190,650 for singles and $231,300 for married couples. While the budget proposal does not specifically indicate the taxable income level at which the 39.6 percent rate would apply, under current law for 2009, the highest tax bracket starts at $372,950 for singles and married couples. Presumably, this taxable income level would not likely change significantly for the new 39.6 percent bracket, although the Obama administration says the taxable income levels for this rate would "vary by filing status." The 28 percent tax rate bracket would be expanded to reflect modifications to the upper limit of that bracket (where the 36 percent bracket would begin).
- Increasing the capital gains and dividends rate to 20 percent for taxpayers in 36 and 39.6 percent tax brackets. The reduced rates on gains on assets held over five years would be repealed. In both cases, the increased rates would apply beginning in 2011.
- Reinstating in 2011 the personal exemption phase-out and itemized deduction limitation, which are scheduled to be fully phased out starting in 2010. Phase-out thresholds would be $200,000 of adjusted gross income for singles and $250,000 for joint filers.

In effect, the Obama budget would raise the top income tax rate, considering these phase-outs, to 40.79 percent from its 2008 level of 35.35 percent.

The Treasury Department estimates these proposed tax increases would raise nearly $615.4 billion over 10 years.

The administration also proposes, as part of its health reform reserve fund, to limit the tax rate at which itemized deductions reduce tax liability (see discussion above for details).

Extension of stimulus tax credits

Finally, the budget would make permanent or expand several of the middle-class tax cut initiatives in the ARRA. Together the proposals for the savers credit and automatic enrollment would cost $60 billion over 10 years.

Making Work Pay Credit – Obama's budget would make permanent the Making Work Pay Credit (enacted for 2009 and 2010 under ARRA), index the beginning of the phase-out range for inflation, and decrease the rate at which the credit phases out from 2 percent to 1.6 percent, beginning in 2011. This would expand the upper end of the credit's phase-out range to $100,000 for singles and $200,000 for couples. Currently, the credit is equal to the lesser of $400 for individuals and $800 for couples or equal to 6.2 percent the taxpayer's earned income, and is refundable even if the taxpayer otherwise has no income tax liability. The credit phases out as an individual's modified adjusted gross income increases from $75,000 ($150,000 married) to $95,000 ($190,000 married). This proposal is the largest component of the president's budget for individual taxpayers and would cost $535 billion over 10 years.

The administration intends to offset the cost of the credit with the auction revenue generated from a proposed cap-and-trade program. Obama has proposed implementing a cap-and-trade program to significantly reduce greenhouse gas emissions by 2020. The program would be structured so that 100 percent of the emission allowances would be auctioned rather than freely allocated by the government. The program is expected begin in fiscal 2012 and to generate more than $624 billion in revenues through 2019.

Child Tax Credit – The ARRA increased the eligibility for the refundable child tax credit by modifying the earned income formula. Under the change, the formula used for determining the refundable child credit is modified to apply to 15 percent of earned income in excess of a base of $3,000, instead of $12,550 for 2009 under prior law. Obama has proposed to: (1) make this tax cut permanent and (2) curtail scheduled future increases in the earnings threshold after 2010, at a cost of $71 billion over 10 years.

Earned Income Tax Credit – The ARRA also temporarily increased the earned income tax credit (EITC) from 40 to 45 percent for 2009 and 2010 for families with three or more qualifying children and increased the income thresholds for the

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phase-out for married couples filing a joint return. Obama's budget would make both of these temporary provisions permanent at a cost of $21billion. Additionally, the budget proposes eliminating the Advanced Earned Income Tax Credit, which allows taxpayers who expect to qualify for the EITC and have at least one qualifying child to receive part of the credit in each paycheck during the year the taxpayer qualifies for the credit. This proposal would save $872 million over 10 years.

American Opportunity Tax Credit – The budget would make permanent the American Opportunity Tax Credit – which currently applies only for 2009 and 2010 – at a cost of $49 billion over 10 years. As enacted in the ARRA, the credit increases the amount of the former Hope credit, extends it to cover four years of schooling, raises the income limits on that credit, and allows up to 40 percent of the credit to be refunded. The credit provides a benefit of up $2,500 per student per year (formerly up to $1,800). The credit applies to 100 percent of the first $2,000 of qualified expenses and 25 percent of the subsequent $2,000. The credit can be claimed for the first four years of post-secondary study in a degree or certificate program.

Saver's Credit – The budget includes an additional provision proposed by Obama on the campaign trail that was not included in the ARRA. The proposal would modify the existing Saver's Credit to provide a 50 percent match on the first $1,000 of retirement savings for married couples filing joint that earn less than $65,000 ($48,750 for heads of households, and $32,500 for singles and married filing separately). The credit would phase out at a 5 percent rate when adjusted gross income exceeds those thresholds. The credit would be deposited automatically into a qualified retirement plan account or IRA and would be fully refundable. The proposal would be effective after 2010.

Automatic enrollment in workplace pension plans – The budget also provides for a system of automatic workplace pensions to operate alongside Social Security. Under this proposal, employers in operation for at least two years that have 10 or more employees would be required to offer an automatic IRA option to employees on a payroll-deduction basis, if the employer did not already provide a qualified retirement plan or SIMPLE. Employees could opt out if they choose. Employers would also claim a temporary tax credit of up to $250 for each employee for a two-year period for making automatic payroll deposit IRAs available. The credit would also be available to employers not required to offer automatic IRAs. The proposal would be effective after 2011.

Outlook

As expanded by this latest release, the Obama administration's tax program has taken on an everything-but-the-kitchen-sink quality. One lesson here is never to underestimate the energy and persistence of this administration. But even though some new details on previous proposals were contained in this release, particularly on the international tax provisions, this document seems to raise as many questions as it answers.

Additionally, many of the groups that the administration has criticized in the press in recent months – financial institutions, insurance companies, oil and gas companies, private equity and hedge funds, and high income/high net worth taxpayers – will find that this budget only further underscores those sentiments.

In the immediate near term, we expect little action on these proposals. Congress has a full agenda focusing on health care reform and climate change legislation leading up to the Memorial Day recess and will not likely turn to these issues until well after they return on June 2.

Ultimately, a number of political variables will affect the likelihood and timing of congressional action on these proposals. Indeed, several factors will work against quick or favorable action on many of them. First, the size and scope of these proposals – particularly in international – are substantial and, together with other legislative priorities, will place tremendous pressure on congressional capacity.

Second, politically it may be difficult to get members to vote for tax increases that do not go into effect for a long period of time. Since many of these controversial measures are not effective until 2011, members may be reluctant to go on the record as supporting them until absolutely necessary.

Third, merely proposing these changes takes some of the pressure off the Obama administration and Congress to address fiscal discipline and deficit issues immediately. Substantial tax law changes could be delayed until after the president's tax reform panel releases its recommendations on December 4, 2009.

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Fourth, at least in the international tax area, early indications suggest that members will resist considering tax law changes of this magnitude outside of the context of a more fundamental look at international and corporate tax reform (including lowering the corporate statutory rate).

The president's budget explicitly identifies the largest pressure for near-term tax increases: health care reform. By setting aside a health reform reserve fund, the president has targeted a discrete set of proposals for early action as Congress moves on health care. Congress may reject the administration's particular recommendations; however, that could simply result in early consideration of some of the other proposals the White House has put forward.

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