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February 16, 2012

Obama Administration Proposes Significant Tax Changes

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On February 13, 2012, the Obama administration released its proposed budget for fiscal year 2013, which includes a number of proposals relating to tax incentives for research and investments in renewable energy property, and numerous changes affecting corporate, partnership and international tax.[1] With respect to individuals, the budget assumes the expiration of various tax cuts enacted during the administration of President George W. Bush, including the preferential rates on dividends and capital gains. Many of the details included in the budget are the same as, or very similar to, those included in prior years.

Although highly anticipated, the budget did not include details on two key tax proposals announced in the president's State of the Union address: those involving corporate tax reform, the broad principles of which now are expected to be released by the end of February, and the possible replacement of the individual alternative minimum tax (AMT) with a new "Buffett rule," which would ensure that all individuals earning more than $1 million pay at least 30 percent of their income in taxes. Some of the more notable proposals contained in the budget are briefly summarized below.[2]

Tax Incentives

The proposed budget would extend some of the "stimulus" provisions that expired at the end of 2011, and would establish several new provisions intended to spur investment in the United States, including:

- *Extend 100 Percent Bonus Depreciation.* The proposal would extend for one year the "bonus" depreciation rule allowing the full expensing of qualified property acquired and placed in service before January 1, 2013 (or January 1, 2014, in the case of certain property eligible for a one-year extension of the placed-in-service date).

- *Modify the Domestic Production Deduction*. The proposal would modify the domestic production deduction under Internal Revenue Code (IRC) Section 199 by prohibiting the use of the deduction after 2012 for production of oil, gas, coal and other hard mineral fossil fuels. The revenue savings from that change would be used to increase the general deduction percentage (currently 9 percent) and to fund an increase in the deduction percentage to 18 percent for activities involving the manufacture of certain advanced technology property.

- *Enhance and Make Permanent the Research and Experimentation Tax Credit*. The proposal would make the Section 41 research and experimentation credit permanent and would increase the rate of the alternative simplified research credit from 14 percent to 17 percent, effective after December 31, 2011.

1 The complete set of budget documents are available from the Office of Management and Budget at: http://www.whitehouse.gov/omb/budget/Overview.

2 Additional details on the tax provisions contained in the budget proposals were published by the Treasury Department in its annual "Greenbook", *available at*: http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

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- *Create a Temporary Tax Credit for New Jobs and Wage Increases.* The proposal would provide a new 10 percent business tax credit of up to $500,000 per employer for increases in wage expense, whether attributable to increased wages for existing employees or to wages for newly hired employees. The credit would be equal to 10 percent of the increase in the qualified employer's 2012 eligible wages over the prior year. For this purpose, "eligible wages" are the employer's wages subject to Old Age Survivors and Disability Insurance (OASDI) taxes; the wage base for determining the maximum amount of OASDI wages per employee is $106,800 for 2011 and $110,100 for 2012. A similar credit would be provided for qualified tax-exempt employers. The proposal would be effective for wages paid during the one-year period beginning on January 1, 2012.

- *Provide Tax Incentives for Locating Jobs and Business Activity in the U.S. and Reduce Tax Deductions for Shipping Jobs Offshore*. The proposal would create a new business tax credit equal to 20 percent of the eligible expenses paid or incurred in connection with "insourcing"[3] a U.S. trade or business. While the creditable costs may be incurred by a foreign subsidiary of a U.S.-based multinational company, the tax credit would be claimed by the U.S. parent company. The proposal also would reduce the tax benefits associated with moving jobs offshore by disallowing deductions for expenses paid or incurred in connection with "outsourcing"[4] a U.S. trade or business. The proposal would be effective for expenses paid or incurred after the date of enactment.

- *Extend and Modify Production Tax Credit for Wind and Certain Other Renewable Energy Facilities*. The proposal would extend the Section 45 production tax credit for wind facilities and the Section 48 investment tax credit for wind facility property to facilities and property placed in service in 2013. The proposal also would extend the Treasury's cash grants in lieu of tax credits program for one year to cover any qualifying property placed in service in 2012 (as well as property on which construction begins in 2012). For qualifying property that is placed in service after 2012, the proposal would replace the Treasury cash grant with a refundable tax credit administered by the Internal Revenue Service. The refundable tax credit would be available for qualifying property on which construction begins in 2009-2013 and would be allowed with respect to property placed in service in 2013 (in the case of property, including wind facility property, that is part of a facility eligible for the Section 45 tax credit) and for property placed in service in 2013-2016 (in the case of other energy property qualifying for the Section 48 tax credit). The qualification requirements for the refundable credit, other than the effective date provisions, would be the same as the qualification requirements currently applicable under the Treasury grant program. Because the refundable credit is being structured as a replacement to the grant program, we understand that eligible projects that commenced construction before this year, and are not completed by the end of this year, would be provided the refundable credit and not a grant. Although the eligible amount should not change, the timing may impact cash flow projections that were used for projects commenced before 2012.

- *Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualifying Advanced Energy Manufacturing Project*. The proposal would authorize an additional $5 billion of tax credits under Section 48C for investments in eligible property used in qualifying advanced energy projects. Under the proposal, taxpayers would be able to apply for a credit with respect

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3 *I.e.*, reducing or eliminating a trade or business (or line of business) currently conducted outside the United States and starting up, expanding or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs.

4 *I.e.,* reducing or eliminating a trade or business (or line of business) currently conducted inside the United States and starting up, expanding or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs.

to part or all of their qualified investment. Application for the additional credits would be made during the two-year period beginning on the date on which the additional authorization is enacted.

- *Extend and Modify the New Markets Tax Credit*. The proposal would authorize the allocation of two more rounds of new market tax credits under Section 45D (for 2012 and 2013) with an allocation of $5 billion per round. The proposal also would permit new market tax credits resulting from qualified equity investments made after December 31, 2011, to offset a taxpayer's alternative minimum tax liability.

- *Create the New Manufacturing Communities Tax Credit*. The proposal would create a new allocated tax credit to support investments in communities which have suffered a major job loss event, such as occurs when a military base closes or a major employer closes or substantially reduces a facility or operating unit that results in a long-term mass layoff. Applicants for the credit would be required to consult with relevant state or local economic development agencies (or similar entities) in selecting those investments that qualify for the credit. The proposal indicates that the credit could operate in a manner similar to the new markets tax credit or the qualifying advanced energy project credit. The proposal would provide approximately $2 billion in credits for qualified investments approved in each of 2012-2014.

Domestic Tax Changes

The budget includes some of the same "revenue raisers" affecting domestic corporations and partnerships as the administration has supported in recent years. Highlights include:

- *Tax Carried Interests as Ordinary Income*. The proposal would tax as ordinary income a partner's share of income from a carried interest in an "investment partnership" that the partner receives in exchange for providing services to the partnership, regardless of the character of the income at the partnership level, as well as gain on the sale of the partnership interest itself. The proposal would only apply to a partnership if (1) "substantially all of its assets" are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets); and (2) "over half of the partnership's contributed capital is from partners in whose hands the interests constitute property held for the production of income." The proposal notes that the Obama administration "remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services" of the carried interest holder. The proposal would be effective for taxable years ending after December 31, 2012.

- *Establish Financial Crisis Responsibility Fee*. The budget proposes to assess a "financial crisis responsibility fee" on certain financial firms in an amount equal to 17 basis points applied against the "covered liabilities." The fee would apply to U.S.-based bank holding companies, thrift holding companies, certain broker-dealers and insured depository institutions. This fee would be imposed on the consolidated risk-weighted assets of financial firms, reduced by its capital, insured deposits and certain loans to small businesses, as reflected on reports filed with federal or state regulators. Insurance companies would also be permitted to deduct certain policy reserves and policy-holder obligations in computing covered liabilities. The fee, which is proposed to take effect January 1, 2014, would be deductible in computing corporate income tax.

- *Repeal Gain Limitation for Dividends Received in Reorganization Exchanges*. In the case of a reorganization transaction, the proposal would repeal the gain limitation rule in Section 356(a)(1) where the exchange has the effect of the distribution of a dividend. The proposal would be effective for taxable years beginning after December 31, 2012.

- *Tax Gain from the Sale of a Partnership Interest on a Look-Through Basis.* The proposal would statutorily provide that gain or loss from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the U.S. to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to effectively connected income property. Subject to a variety of exceptions, the transferee of the partnership interest would be required to withhold 10 percent of the amount realized on the sale or exchange of the partnership interest after December 31, 2012.

- *Eliminate Oil and Gas Preferences*. In addition to the changes to the domestic production deduction described above, the budget proposes to repeal the enhanced oil recovery credit, the credit for oil and gas produced from marginal wells, the expensing rules for intangible drilling costs, the deduction for tertiary injectants, the exception to the passive loss rules for working interests in oil and natural gas properties, and the percentage depletion rules for oil and natural gas wells. The budget also proposes to increase the amortization period for geological and geophysical expenditures from two to seven years.

- *Eliminate Coal Preferences*. In addition to the changes to the domestic production deduction described above, the budget proposes to repeal the expensing rules for mining exploration and development costs, the percentage depletion rules for hard mineral fossil fuels, and capital gain treatment for coal and lignite royalties.

- *Repeal LIFO and LCM Inventory Accounting Methods.* The budget proposes to repeal the last-in, first-out (LIFO) and lower-of-cost-or-market (LCM) inventory accounting methods. The increase in income resulting from conversion from LIFO to first-in, first-out (FIFO) accounting would be taxed ratably over 10 years, starting in 2014. Similarly, the impact of the LCM repeal would be taken into account ratably over four years, also starting in 2014.

- *Deny Deduction for Punitive Damages*. The budget would eliminate the deduction for punitive damages, whether pursuant to a judgment or settlement of a claim, effective for damages paid or incurred after 2013.

International Tax Changes

The budget includes a number of proposals affecting the tax treatment of income earned outside the United States. Highlights include:

- *Tax Excess Returns Associated with Outbound Transfers of Intangibles.* The proposal would require U.S. persons that directly or indirectly transfer an intangible from the United States to a related controlled foreign corporation to include as subpart F income the "excess intangible income" from transactions connected with or benefiting from such intangible if the underlying income is subject to a low foreign effective tax rate. In the case of an effective tax rate of 10 percent or less, the proposal would treat all excess intangible income as subpart F income, and would then phase out ratably for effective tax rates of 10-15 percent. "Excess intangible income" would equal the excess of gross income from transactions "connected with or benefiting from"

the intangible over the costs (excluding interest and taxes) properly allocable to such income, increased by a percentage markup. Applicable transfers would include sales, leases, licenses, and shared risk or development agreements, including cost sharing agreements. Excess intangible income would also be a separate category of income for purposes of the foreign tax credit limitation under Section 904. The proposal would be effective for transactions in taxable years beginning after December 31, 2012.

- *Expand the Definition of Intangible Property for Purposes of Sections 367(d) and 482.* The proposal provides that intangible property, for purposes of Sections 367(d) and 482, would include workforce in place, goodwill and going concern value. It also would allow the IRS to value multiple intangibles properties transferred together on an aggregate basis where that achieves a more reliable result and to take into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken. The proposal would apply to taxable years beginning after December 31, 2012.

- *Extend Subpart F Exceptions*. The proposal would extend through December 31, 2013, the subpart F "active financing" and "look-through" exceptions.

- *Defer Deduction of Interest Expense Related to Deferred Income of Foreign Subsidiaries*. The proposal would defer the deduction of interest expense properly allocated and apportioned to stock of a foreign corporation that exceeds an amount proportionate to the taxpayer's *pro rata* share of income from such subsidiaries that is currently subject to U.S. tax. Directly earned foreign source income, such as income earned by a taxpayer through a branch, would be considered currently subject to U.S. tax for these purposes. Interest expense that is deferred under the proposal would be deductible in a subsequent tax year to the extent that the amount of interest expense allocated and apportioned to stock of foreign subsidiaries in that year is less than the annual limitation for that year. The proposal would be effective for taxable years beginning after December 31, 2012.

- *Determine the Foreign Tax Credit on a Pooling Basis.* The proposal would require a U.S. taxpayer to compute its deemed paid foreign tax credit based on a single pool reflecting the aggregate foreign taxes and earnings and profits of all foreign subsidiaries for which it could claim the credit. The foreign tax credit for a taxable year would be limited to an amount proportionate to the taxpayer's *pro rata* share of the consolidated earnings and profits of such foreign subsidiaries repatriated in that taxable year that are currently subject to U.S. tax. Foreign taxes deferred under this proposal in prior years would be creditable in a subsequent taxable year to the extent that the amount of deemed paid foreign taxes in the subsequent year are less than the annual limitation for that year. The proposal would be effective for taxable years beginning after December 31, 2012.

- *Disallow the Deduction for Non-Taxed Reinsurance Premiums Paid to Affiliates.* The proposal would (1) deny an insurance company a deduction for premiums and other amounts paid to affiliated foreign companies with respect to reinsurance of property and casualty risks to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) exclude from the insurance company's income, in the same proportion in which the premium deduction was denied, any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a premium deduction is wholly or partially denied. The proposal would permit a foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction

under this proposal to elect to treat the premiums and the associated investment income as effectively connected with the conduct of a trade or business in the U.S. and attributable to a permanent establishment for tax treaty purposes. Reinsurance income treated as effectively connected under this rule would be treated as foreign source income and would be a separate category of income under Section 904. The proposal would apply to policies issued in taxable years beginning after December 31, 2012.

- *Limit Earnings Stripping by Expatriated Entities.* The proposal would modify the existing "earnings stripping" rules under Section 163(j) to limit the deductibility of interest paid by an expatriated entity (as defined in Section 7874) to related persons, by (1) eliminating the current law debt-to-equity safe harbor; (2) reducing the adjusted taxable income threshold from 50 percent to 25 percent; (3) limiting the carryforward for disallowed interest to 10 years, and (4) eliminating the carryforward of excess limitation. The proposal would be effective for taxable years beginning after December 31, 2012.

- *Modify Foreign Levy Rules for Dual Capacity Taxpayers.* The proposal would replace regulatory guidelines that determine the amount of a foreign levy that qualifies as a creditable tax in the case of a foreign levy paid by taxpayers that also receive a specific economic benefit from the levying country ("dual capacity taxpayers"). It would also treat as a creditable tax a portion of the levy not in excess of the foreign levy that would be paid if the taxpayer were not a dual capacity taxpayer. The proposal would also incorporate the limitation rules of Section 907 into a separate category in Section 904 for foreign oil and gas income. Treaties that allow a credit for taxes paid or accrued on certain oil or gas income would not be affected by the proposal. The proposal would be effective for taxable years beginning after December 31, 2012.

- *Prevent use of Leveraged Distributions from Related Foreign Corporations to Avoid Dividend Treatment.* The proposal would provide that if one foreign corporation funds a second, related foreign corporation with a principal purpose of avoiding dividend treatment on distributions to a U.S. shareholder, the U.S. shareholder's basis in the stock of the second foreign corporation will not be taken into account for purposes of determining the treatment of a distribution under Section 301. The proposal would apply to funding transactions completed after December 31, 2012, including capital contributions, loans, or distributions to the second foreign corporation, regardless of whether the funding transaction occurs before or after the distribution.

- *Extend Section 338(h)(16) to Certain Asset Acquisitions.* Section 338(h)(16), which generally provides that the deemed asset sale resulting from a Section 338 election is not treated as occurring for purposes of determining the source or character of any item for purposes of applying the foreign tax credit rules to a seller, does not presently apply to certain types of covered asset acquisitions subject to the credit disallowance rules under Section 901(m). The proposal would extend the application of Section 338(h)(16) to any covered asset acquisition (within the meaning of Section 901(m)) completed after December 31, 2012.

- *Remove Foreign Taxes from a Section 902 Corporation's Foreign Tax Pool When Earnings are Eliminated.* Foreign income taxes paid by a foreign corporation would be reduced if a transaction results in the elimination of a foreign corporation's earnings and profits (other than as a result of a deemed or actual dividend or a Section 381 transaction). In such a circumstance, the amount of foreign income taxes that would be reduced would equal the amount of foreign taxes associated with the eliminated earnings and profits. The proposal would be effective for transactions occurring after December 31, 2012.

Changes to Taxation of Individuals

The budget proposes to allow many of the Bush tax cuts to expire at the end of 2012 and to impose additional limitations on the use of tax deductions for individuals in the higher tax brackets. The key changes include:

- *Reinstate the 36 Percent and 39.6 Percent Tax Rates.* The proposal would replace part of the 33 percent and all of the 35 percent tax rate brackets with the 36 percent and 39.6 percent brackets in effect prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act in 2001. The 36 percent tax rate bracket would begin at taxable income level calculated as the appropriate adjusted gross income (AGI) threshold minus the appropriate standard deduction and one personal exemption (two for married taxpayers filing jointly). The AGI thresholds would be (1) $250,000 for married taxpayers filing joint returns; (2) $225,000 for head-of-household taxpayers; (3) $200,000 for single taxpayers; and (4) $125,000 for married taxpayers filing separately. The AGI thresholds are at 2009 levels and would be indexed for inflation thereafter. These changes will take effect on January 1, 2013, unless Congress acts to extend the Bush tax cuts before that date.

- *Tax Qualified Dividends as Ordinary Income.* The proposal would allow the current reduced tax rates applicable to qualified dividend income to expire after December 31, 2012, for income that would otherwise be taxable in the 36 percent or 39.6 percent brackets. Notably, when taking into account the additional 3.8 percent surtax on passive income enacted in 2010 as part of the larger healthcare legislation, which takes effect on January 1, 2013, dividends received by individuals in the top tax bracket will be subject to federal tax at a combined rate of 43.4 percent in 2013.

- *Tax Long-Term Capital Gains at a 20 Percent Rate.* The proposal would allow the current reduced tax rates on long-term capital gains to expire after December 31, 2012, for capital gain income that, in the absence of any preferential treatment of long-term capital gains, would be taxable in the 36 percent or 39.6 percent brackets. It would also repeal the special reduced rate on gains from assets held over five years. Accordingly, the long-term capital gains tax rate for upper-income taxpayers would generally be 20 percent.

- *Reinstate Phase-Outs of Personal Exemptions and Itemized Deductions.* The proposal would allow the phase-outs of personal exemptions and itemized deductions for upper-income taxpayers to come back into effect after 2012. These phase-outs effectively eliminate the benefit of the personal exemptions and limit the availability of most itemized deductions, as income increases above certain thresholds.

- *Reduce the Value of Certain Tax Expenditures.* In addition to the phase-outs, the budget proposes to limit the tax value of specified deductions or exclusions from AGI and all itemized deductions to 28 percent of the specified exclusions and deductions that would otherwise reduced taxable income in the 36 percent and 39.6 percent tax brackets; a similar limitation would apply to the AMT. The proposal would apply to itemized deductions after they have been reduced by the statutory limitation on certain itemized deductions for higher income taxpayers. The proposal would be effective for taxable years beginning after December 31, 2012.

- *Extend Estate and Transfer Tax Thresholds*. The budget proposes to make permanent the estate and transfer tax thresholds as they existed in 2009. Accordingly, the top rate would be 45 percent,

subject to an exclusion amount of $3.5 million for the estate and generation-skipping transfer taxes, and of $1 million for the gift tax. These changes would take effect after December 31, 2012. Absent legislation, the rates and exclusion amounts will revert to pre-2001 levels (55 percent top rate and $1 million exclusion), so there will be significant pressure on Congress to act before year-end.

Concluding Observations

Many of the provisions included in the administration's budget proposals are carryovers from prior years. With the upcoming elections, and the continued debate in Washington over the size of government and the need to address deficit reduction without harming the economic recovery, it is uncertain at best if any of these proposals will be enacted in the near term. However, many of the themes in these proposals likely will be at the forefront of the electoral discussion over the coming months. Moreover, if the corporate tax reform proposal that the Treasury Department is expected to release later this month follow expectations, it is likely that Congress will be asked to consider the elimination of most corporate tax preferences in exchange for a significantly reduced corporate tax rate, perhaps in conjunction with a shift towards a territorial system of taxation. Treasury only will be presenting broad principles — not specific proposed legislative language — with its corporate tax reform proposal, which makes the timing and content of future reform hard to predict for now.

With respect to the individual provisions, unless Congress acts this year, most of the items proposed will become law because the Bush tax cuts were enacted on a temporary basis only. Thus, the increases to the individual tax rates, the elimination of the preferential rates for dividends and capital gains, and increases in estate and gift taxes will happen automatically. Many observers in Washington anticipate a "lame duck" session of Congress after the elections that will attempt to extend at least some of the Bush tax cuts. It is likely that any such discussion also would include attempts to extend other temporary provisions that expired last year or that are scheduled to expire soon, including, for example, the research credit, the production and investment tax credits for wind, and the grant program for wind and other renewable resources.