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Obama Administration Releases Framework for Business Tax Reforms

On February 22, 2012, the White House and the Department of the Treasury jointly released "The President's Framework for Business Tax Reform" (the Framework), which includes ideas for reforming the federal income tax on business income.[1] In support of its proposals, the Framework describes the current rules as "uncompetitive," "inefficient" and "too complicated" and states that those rules distort business-making decisions and fail to sufficiently encourage job creation and investment in the United States. Among other things, the Framework would significantly revise the corporate income tax system by reducing corporate income tax rates and eliminating many existing tax preference items, potentially expand the reach of the corporate income tax to large partnerships and other passthrough entities, and reinforce the existing worldwide system of taxation with a new minimum tax on foreign earnings. The Framework sets forth principles and high-level explanations for how these proposals might be drafted but leaves many of the details for further development through the legislative process.[2] Some of the more notable proposals in the Framework are discussed below.

Corporate Income Tax Reform

The Framework proposes to reduce the corporate income tax rate from 35 percent to 28 percent, stating that this reduced rate would be in line with other advanced countries. For manufacturing companies, the effective tax rate would be further reduced through the existing Internal Revenue Code (IRC) Section 199 domestic production activities deduction. Under the proposal, most domestic manufacturers would have an effective tax rate of 25 percent, and those involved in certain advanced manufacturing activities would enjoy even lower rates.

To offset the revenue loss attributable to the reduced corporate income tax rate, the Framework would eliminate "dozens of business tax loopholes and tax expenditures" and reform the corporate tax base. Some of the provisions were previously announced in the FY2013 Budget, including the proposals to (i) repeal the use of the "last-in, first-out" method of accounting for inventories, (ii) eliminate various oil and gas tax preferences, such as percentage depletion and the expensing of intangible drilling costs, and (iii) tax "carried interests" in partnerships at ordinary income rates. The newer and more significant proposals are those that would:

- eliminate the accelerated depreciation of business assets,
- limit the deductibility of corporate interest expense, and
- subject large passthrough entities (such as partnerships) to the corporate income tax.

1 The Framework is available at: http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

2 Many aspects of the Framework were previously announced in the Obama administration's proposed budget for fiscal year 2013 (the FY2013 Budget). A brief overview of the tax proposals contained in the FY2013 Budget is available at http://www.skadden.com/newsletters/Obama_Administration_Proposes_Significant_Tax_Changes.pdf.

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The proposed change in the tax treatment of large passthrough entities could have significant effects on numerous sectors, including publicly traded master limited partnerships and many privately held enterprises that presently are organized as partnerships or subchapter S corporations. If this proposal were enacted, income that otherwise would be taxed at the top ordinary rate of 39.6 percent in 2013 would instead be subject to a corporate income tax of 28 percent *plus* a dividend tax of approximately 44 percent on earnings distributed to partners or shareholders.[3] Due to the limited details provided in the Framework, it is not clear whether exceptions would be provided for certain passthrough entities that would otherwise be subject to corporate income taxation under the Framework's proposal. For example, the 2005 report of President George W. Bush's Advisory Panel on Federal Tax Reform suggested that if large partnerships and S corporations were subjected to an entity-level tax, exceptions should be provided for regulated investment companies (*i.e.*, mutual funds or RICs) and real estate investment trusts (REITs).[4] If exceptions are provided for RICs and REITs, and perhaps for master-limited partnerships, it is not clear how much of an impact the proposal really would make. Moreover, for businesses that historically distribute most of their earnings, as is the case with many service partnerships, for example, it is not clear whether the entity-level tax would have much effect because the entity presumably would deduct salaries paid to its owners, who would then pay tax on their salaries at the individual tax rates. Of course, if the entity-level tax is not adopted for large passthroughs, but the corporate rate is reduced as proposed, such that the differential between the corporate income tax rate and the top individual income rate exceeds 10 percentage points, then many passthrough entities and unincorporated businesses may need to assess whether that differential is significant enough to warrant converting to corporate form, thereby permitting them to take advantage of deferral opportunities.

Importantly, and despite the Framework's seeming focus on removing tax expenditures from the U.S. tax system, the Framework proposes to expand and/or make permanent a few tax expenditures. For example, the Framework proposes to make the IRC Section 41 simplified research and experimentation credit permanent and to increase the rate of that credit from 14 percent to 17 percent. The Framework also proposes to make permanent the IRC Section 45 tax credit for the production of electricity from renewable resources such as wind and solar. Also, as proposed in the FY2013 Budget, the existing Treasury grant program would not be extended, but the production tax credit would become refundable. It appears that other incentives, however, such as the investment tax credit for certain energy projects, would be allowed to expire under the Framework.

The Framework also suggests that in order to increase transparency, corporate tax reform should reduce disconformities between financial accounting and tax reporting and could involve requiring greater disclosure of annual corporate income tax payments. Unless full conformity between financial accounting and tax reporting is required, however, it is difficult to understand how the disclosure of annual corporation income tax payments would assist investors in understanding a company's financial position because the investors would not have the additional information (such as the amount of the corporation's taxable income, the source of its income, the amount of any tax attributes utilized, etc.) necessary to properly understand the import of the corporate income tax payment.

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3 Under current law, the top tax rate applicable to ordinary income earned by individuals will increase to 39.6 percent on January 1, 2013, and the phase-outs of personal exemptions and itemized deductions will be reinstated. When factoring in these changes and the new 3.8 percent surtax on certain investment income that also takes effect on January 1, 2013, dividends received by individuals in the top bracket will be subject to federal income tax at an effective rate of approximately 44 percent.

4 The August 2010 report on tax reform options approved by President Obama's Economic Recovery Advisory Board discussed a similar proposal to subject some passthrough entities to corporate income taxation, but did not make a specific recommendation regarding possible exceptions.

International Tax Reform

Very generally, the primary goals of the Framework's international tax proposals are to maximize investment in the United States and to minimize the erosion of the U.S. tax base. In this vein, the Framework seeks to move the United States international tax system to a more pure worldwide system as it proposes to prevent the deferral of U.S. income tax on the foreign income of U.S. multinational corporations by imposing a minimum tax rate on such foreign income; foreign tax credits would be allowed for income taxes paid on such foreign income to the foreign host country. The Framework thus makes clear that the President has determined that it is not appropriate for the United States to implement a territorial tax system. This is particularly interesting as many other advanced countries have implemented territorial tax systems. That is, if it is appropriate to reduce the U.S. corporate income tax rate to be in line with the majority of the OECD member nations (as the Framework proposes to do), it seems unusual then to take the position that the United States should tax foreign income in almost the exact opposite manner of those very same countries.

Other international tax proposals in the Framework include proposals to (i) disallow deductions for the expenses of moving operations outside the United States, (ii) provide a 20 percent income tax credit for the expenses of moving operations into the United States, (iii) tax currently excess profits associated with shifting intangible assets abroad, and (iv) disallow interest expense deductions attributable to overseas investment until the related income is taxed in the United States. Each of these proposals was previously announced in the FY2013 Budget, and the Framework does not set forth significant additional detail on how these proposals might be drafted.

Small Business Tax Reform

The Framework includes a number of proposals that are intended to benefit small businesses. For example, the Framework proposes to (i) expand IRC Section 179 to permit small business, on a permanent basis, to expense up to $1 million per year in qualified investments, and (ii) modify IRC Section 448 to permit small businesses with up to $10 million in gross receipts to use the cash method of accounting.

Separately, as noted above, the Framework proposes to subject certain large partnerships and other passthrough entities to the corporate income tax. While the Framework states that the Administration does not intend to subject small businesses to that change, the definition of "small business" for this purpose will be very important, and this change may be of concern to growing or expanding businesses.

Concluding Observations

With the release of the Framework, the President has advanced the debate on corporate tax reform, adding another approach to those that have been discussed over the past few years. The proposal to reduce the corporate income tax rate to 28 percent or less will be welcomed by many, but funding the cost of that rate reduction (*i.e.*, the reduction or elimination of tax preferences currently available) will be subject to considerable debate. The proposals to subject large partnerships and other passthrough entities to the corporate income tax and to expand the worldwide taxation of foreign income are likely to receive the most serious scrutiny as the debate on corporate tax reform moves forward.

As we observed when the FY2013 Budget was released earlier this month, 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. It is likely that a "lame duck" session of Congress after the November elections will attempt to extend at least some of the expiring Bush tax cuts, as well as some

of the corporate preference items, such as the research credit and the renewable energy production tax credit. Although we anticipate the tax-writing committees in Congress will devote time to the ideas set forth in the Framework, as well as those set forth in other reform proposals, over the next few months, it is not likely that there will be sufficient time during a "lame duck" session for Congress to make progress on larger reform like that proposed in the Framework. Accordingly, the Framework might best be viewed as the latest salvo in what appears to be a very long march towards tax reform.