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President's FY 2012 budget proposals include scores of tax proposals for businesses, individuals, and investors (02/17/2011)

Federal Taxes Weekly Alert,

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On February 14, the President issued his FY 2012 budget proposals, accompanied by the Treasury's release of its "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" (colloquially referred to as the Green Book). These documents reveal that the Administration has a robust agenda of tax proposals it will try to get Congress to enact. There are scores of changes for businesses, individuals and investors.

 **RIA observation:** It could be a busy year for tax legislation, even if only a fraction of the tax changes in the budget are enacted.

 **RIA observation:** A number of provisions in the President's FY 2011 budget wound up being enacted, such as the removal of cell phones from the listed property category, enhanced writeoffs for business buying machinery and equipment, and the extension of a number of popular tax breaks for individuals.

Tax proposals for businesses and investors include:

- Expanding the research credit by nearly 20% and making it permanent.
- Revamping the Federal Unemployment Tax Act (FUTA) tax. Currently, the tax is 6.2% through June of 2011, and 6.0% for the remainder of calendar year 2011 and later years. It's levied on the first \$7,000 paid each employee as wages during the calendar year. Under the budget proposal, the FUTA rate would remain at 6.2% after June of 2011, and, beginning in 2014, the FUTA wage base would be raised to \$14,000.
- Repealing the use of the LIFO inventory accounting method. Taxpayers currently use this method would be required to write up their beginning LIFO inventory to its FIFO value in the first tax year beginning after Dec. 31, 2012, but this one-time increase in gross income would be taken into account ratably over ten years, beginning with the first tax year beginning after Dec. 31, 2012.
- Repealing current law's boot-within-gain limitation in the case of any reorganization transaction if the exchange has the effect of the distribution of a dividend, as determined under Code Sec. 356(a)(2) . This would apply for tax years beginning after Dec. 31, 2011.
- Taxing as ordinary income a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the

character of the income at the partnership level. The partner would have to pay self-employment taxes on such income, and gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain. In general, an ISPI would be defined as a carried interest in an investment partnership that is held by a person who provides services to the partnership. These changes would apply for tax years beginning after Dec. 31, 2011.

- Barring a deduction for punitive damages. Where the liability for punitive damages is covered by insurance, such damages paid or incurred by the insurer would be included in the gross income of the insured person. These changes would apply to damages paid or incurred after Dec. 31, 2012.
- Repealing the lower-of-cost-or-market inventory accounting method, and the subnormal goods method, effective for tax years beginning after Dec. 31, 2012.
- Repeal the additional information reporting requirements imposed by the Affordable Care Act, but requiring businesses to file an information return for payments for services or for determinable gains aggregating to \$600 or more in a calendar year to a corporation (except a tax-exempt corporation). Regulatory authority would be provided to make appropriate exceptions where reporting would be especially burdensome. Information returns would not be required for payments for property. These changes would be effective for payments made after Dec. 31, 2011.
- Requiring all corporations and partnerships that must file Schedule M-3 to file returns electronically, effective for tax years beginning after Dec. 31, 2011.
- Permitting IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law. This would apply upon enactment, with a transition rule.
- Eliminating tax preferences (e.g., expensing of intangible drilling costs, enhanced oil recovery credit, production tax credit for marginal wells, percentage depletion) for oil, gas and coal companies.
- Replacing the current Code Sec. 179D deduction for energy efficient commercial building property with a more generous and effective tax credit that will encourage building owners to retrofit their properties.
- Imposing a financial crisis responsibility fee on certain liabilities of the largest firms in the financial sector. The fee would apply after 2012, would be reported on the federal income tax return, and would be deductible in computing corporate tax.
- Effective for forward contracts entered into after 2011, requiring a corporation that enters into a forward contract to issue its stock to treat a portion of the payment on the forward issuance as a payment of interest.
- Repealing the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers or directors, other than 20% owners of a business that is the owner or beneficiary of the contracts. This would apply to contracts issued after Dec. 31, 2011, in tax years ending after that date. Any material increase in the death benefit or other material change in the contract would be treated as a new contract except that in the case of a master contract, the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.
- Effective for tax years beginning after the enactment date, requiring dealers in commodities, commodities derivatives dealers, dealers in securities, and dealers in options to treat the income from their day-to-day dealer activities in Code Sec. 1256 contracts as ordinary in character, not capital.
- Effective on the enactment date, amending the definition of "control" in Code Sec. 249(b)(2) to incorporate indirect control relationships of the nature described in Code Sec. 1563(a)(1) .

- Reinstating Superfund excise taxes for periods after 2011 and before 2022, and reinstating the corporate environmental income tax for tax years beginning after 2011 and before 2022.
- Reforming the current Code Sec. 30D credit for purchasers of electric vehicles by allowing dealers to claim it, with clear transparency requirements to ensure the benefit of the credit is passed on to consumers.
- Making permanent the Code Sec. 179 rule allowing up to \$125,000 to be expensed. (Under current law, the maximum expensing amount is \$500,000 for tax years beginning in 2010 or 2011, dropping down to \$125,000 for tax years beginning in 2012, and then falling to \$25,000 for tax years beginning after 2012.)
- Making permanent the Code Sec. 1202 rule excluding all gain on qualified small business stock. (Under current law, the exclusion applies only for disposition of qualified stock acquired before 2012.)
- Extending Build America Bonds (BABs) at a 28% subsidy rate, and expand them to cover a broader set of investment such as capital infrastructure projects and financing for nonprofit colleges and hospitals.
- Replacing the current tax deduction for energy efficient commercial building property with a more generous and effective tax credit that will encourage building owners to retrofit their properties.

Tax proposals for reform of international rules include the following:



RIA observation: All changes would be effective for tax years beginning after Dec. 31, 2011, except that change (3) would be effective for transactions in taxable years beginning after that date, and change (5) would apply for policies issued in taxable years beginning after that date):

(1) Deferring the deduction of interest expense properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax. Foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax; thus, the proposal would not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign source income (e.g., royalty income) would be similarly treated. Deferred interest expense would be deductible in a subsequent tax year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during that deduct previously deferred interest expenses in certain cases.

(2) Requiring a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis, based on aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in Code Sec. 902(b)).

(3) Providing that if a U.S. person transfers (directly or indirectly) an intangible from the U.S. to a related controlled foreign corporation (a "covered intangible"), then certain excess income from transactions connected with or benefitting from the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate. The transfer of an intangible would include a transfer by way of a sale, lease, license, or any shared risk or development agreement (including any cost sharing arrangement)). This subpart F income would be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under Code Sec. 904 .

(4) Clarifying the definition of intangible property for purposes of Code Sec. 367(d) and Code Sec. 482 to include workforce in place, goodwill and going

concern value, and clarifying that where multiple intangible properties are transferred, IRS may value the intangible properties on an aggregate basis where that achieves a more reliable result. Also, IRS could value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

(5) Denying an insurance company a deduction for reinsurance premiums paid to affiliated foreign reinsurance companies 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 excluding from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

(6) Revising Code Sec. 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons. The current law debt-to-equity safe harbor would be eliminated. The 50% adjusted taxable income threshold for the limitation would be reduced to 25%, the carryforward for disallowed interest would be limited to ten years, and the carryforward of excess limitation would be eliminated.

(7) Allowing a dual capacity taxpayer to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual-capacity taxpayer. This would replace the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax.

Tax proposals for individuals include:

... Allowing the 2001 and 2003 tax cuts to expire for households making more than \$250,000 per year, and restoring the estate tax to 2009 levels. Both these changes would be effective beginning in 2013.

... Limiting the tax subsidy for itemized deductions for high-income families to 28%.

... Making the American Opportunity Tax Credit permanent (under current law, it won't apply after 2012).

... Permitting borrowers to exclude loan forgiveness on certain student debt provided that they have met their repayment obligations for the 25-year period required by Federal repayment programs. (For many students on income-contingent or income-based repayment plans, at the end of their payment plans any outstanding balance on their loans is forgiven. Under current law, those forgiven amounts are taxable.)

... Increasing tax credits for child care and dependent care expenses, and permanently expanding the Earned Income Tax Credit for families with 3 or more Children.

... Providing for "Automatic IRAs" in the workplace and giving employers automatically enrolling their employees in IRAs tax credits of up to \$250 a year for two years.

... Eliminating required minimum distributions (RMDs) for taxpayers with aggregate IRA and tax favored retirement plan account balances of \$50,000 or less, effective for taxpayers attaining age 70-1/2 after Dec. 31, 2011.

... Allowing a surviving non-spouse beneficiary to make 60-day rollovers from a retirement plan or IRA to a non-spousal inherited IRA, effective for distributions after Dec. 31, 2011.