DAVIS POLK & WARDWELL

Date: May 12, 2009

To: Interested Persons

Re: Highlights of the Administration's 2010 Revenue Proposals

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Treasury's General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals were released on May 11, 2009. The Explanations cover a number of items of potential interest, including some new proposals and some further detail on previously announced proposals. The proposals relate broadly to the "economic substance" doctrine, carried interests, international tax, financial instruments, corporate tax, insurance companies and products, withholding, information reporting and other administrative provisions, and individual taxes. Selected proposals are highlighted below.

Economic Substance Doctrine

- codify the concepts of "objective economic substance" and "nontax business purpose," with a heightened 30% penalty (absent adequate disclosure) for, and no deduction for interest on tax liability relating to, understatements resulting from transactions that lack economic substance, for transactions entered into after the date of enactment ("DOE").

Carried Interests

- tax "carried interest" allocations (as well as income and gain derived by service providers from certain other "disqualified interests" in entities receiving services, including convertible or contingent debt, options and derivative instruments) as ordinary income and impose self-employment tax thereon, beginning in the first tax year beginning after December 31, 2010.[1]

[1] For purposes of this memorandum, "beginning in 2011" means "beginning in the first tax year beginning after December 31, 2010."

International

- prohibit a foreign entity from electing to be "disregarded" unless its owner is organized or created under the laws of the same jurisdiction (or, generally, is a US person), beginning in 2011;

- defer deductions for expenses (other than research and experimentation expenses) "properly allocated and apportioned" under current Treasury regulations to foreign-source income not currently subject to US tax, beginning in 2011;

- require that deemed paid foreign tax credits (and associated earnings and profits) be determined on a consolidated basis based on the average foreign tax rate applicable to all foreign-source income of the taxpayer and its CFCs with respect to which the taxpayer is or would be eligible to claim a deemed paid credit (it is not clear whether, for example, this would permit an *increase* in the tax creditable against relatively low-taxed repatriated income), beginning in 2011;

- adopt a matching rule to prevent (for example, in the case of certain "hybrid" arrangements) the separation of creditable foreign taxes from the "associated" foreign income, beginning in 2011;

- clarify that the definition of intangible property for purposes of Sections 367(d) and 482 includes workforce in place, goodwill and going concern value; that for transfers of multiple properties the IRS may determine value on an aggregate basis (presumably intended to capture "synergy value"); and that intangible property must be valued at its highest and best use as determined in transactions between unrelated persons, beginning in 2011;

- modify the earnings stripping rules applicable to "expatriated companies" (retroactively applying Section 7874 principles) to eliminate the current debt-to-equity safe harbor and the ability to carry forward excess limitation, reduce the adjusted taxable income threshold to 25% for interest paid to related parties (but not interest paid to unrelated parties on debt that is subject to a related-party guarantee, which would remain subject to a 50% adjusted taxable income threshold) and reduce carryforwards of disallowed interest to ten years, in each case beginning in 2011;

- repeal the "boot-within-gain" limitation of Section 356(a)(1) (capping dividend recognition by gain realized with respect to the stock exchanged) in cross-border reorganizations if the acquiror is foreign and the exchange has the effect of a dividend within the meaning of Section 356(a)(2) (apparently targeting transactions such as "deadly Ds," described in Notice 2008-10), beginning in 2011;

- repeal the "80/20" rule treating dividends from US corporations as foreign-source if they are primarily engaged in offshore operations, beginning in 2011; and

- allow crediting of foreign taxes paid by "dual-capacity entities" (entities subject to foreign levies that receive specific economic benefits from the levying country) only if the foreign government generally imposes an income tax, beginning in 2011.

Financial Instruments

- treat amounts paid under equity swaps to non-US persons beginning in 2011 as US-source income potentially subject to US withholding tax to the extent attributable to dividends paid by a US corporation, unless the swap meets the criteria of a specified safe harbor (which applies if (i) the contract does not require the foreign person to post more than 20% of the value of the underlying stock as collateral; (ii) the contract doesn't address the hedge position of the counterparty; (iii) the underlying stock is publicly traded and the notional amount of the swap represents less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume; (iv) the foreign person doesn't sell the stock to the counterparty at the inception of the contract or buy the stock from the counterparty at the termination of the contract; (v) the prices of the equity that are used to measure the parties' entitlements or obligations are based on an objectively observable price; and (vi) the swap has a term of at least 90 days);

- revoke Notice 97-66 and issue guidance that eliminates the benefits of foreign-to-foreign US securities lending transactions but "minimizes over-withholding";

- require a corporation that enters into a forward contract to issue its stock to treat a portion of the forward purchase price as interest income, for contracts entered into beginning in 2011;

- require commodities, commodities derivatives, securities and equity options dealers to treat their income under Section 1256 as ordinary in character, beginning in tax years after the DOE; and

- expand the Section 249 limit on deductibility of repurchase premium related to convertible or exchangeable debt, by modifying the definition of "control" to include indirect control (*i.e.*, of a second- or lower-tier subsidiary), and perhaps (though not clear) to provide that the test of an 80% "control" relationship is determined by aggregate vote or value, beginning on the DOE.

Corporate

- repeal LIFO inventory accounting for tax years beginning after December 31, 2011, with a transition year in which inventory would be restated to FIFO (the income from which would be spread over the transition year and the following seven years);
- repeal "lower of cost or market" inventory accounting, and limit the "retail method," for taxable years beginning after twelve months after the DOE;
- deny deductions for punitive damages paid by taxpayers, whether upon a judgment or in settlement of a claim, and treat insurance payments of punitive damages claims as income to the insured, beginning in 2011;
- work with Congress to extend the net operating loss carryback period for "more taxpayers" than eligible small businesses (for which the general carryback period was extended to five years earlier this year);
- make the research and experimentation tax credit permanent;
- extend through December 31, 2010 the subpart F "active financing" and "look-through" exceptions, as well as certain other expiring provisions;
- eliminate several oil and gas "preferences," including (i) the investment tax credit for enhanced oil recovery projects, (ii) the production tax credit for oil and gas from marginal wells, (iii) expensing or five-year amortization of intangible drilling costs, (iv) the qualified tertiary injectant expense deduction, (v) the passive loss exception for working interests in oil and gas properties, (vi) percentage depletion with respect to oil and gas wells, (vii) the deduction for domestic gross receipts derived from the disposition of oil or natural gas, and (viii) accelerated amortization of geological and geophysical expenditures incurred by independent producers in connection with US oil and gas exploration, each beginning in 2011; and
- develop a proposal to impose an excise tax on certain oil and gas produced on the Outer Continental Shelf in the future.

Insurance Companies and Products

- require the buyer of a life insurance contract with a death benefit greater than $1 million to report the purchase price and other information to the insurance company and the seller, eliminate the application of the exceptions to the "transfer-for-value" rule of Section 101(a)(2) to "buyers" of policies (which, while not clear, might be intended to include certain entities that receive policies in a carryover basis transaction), and require insurance companies to report payments of policy benefits to buyers, for sales or assignments of interests in life insurance policies, and death benefits payments made, beginning in 2011;

- modify the calculation of insurance companies' "share" of dividends received in separate accounts for purposes of calculating the insurance company's dividends-received deduction, beginning in 2011;

- repeal the exception from the *pro rata* interest expense disallowance rule for life insurance contracts covering employees, officers or directors (other than 20% owners of the business that is the owner of or beneficiary under the contract), for contracts entered into after the date of enactment; and

- require life insurance companies to report to the IRS information relating to contracts invested in whole or part in one or more "private separate accounts" (not clearly defined, but appears to be an account at least 10% of the value of which is attributable to policies owned by a related group of persons), including the policyholder's accumulated untaxed income, total account value, value invested in private separate accounts and other items, beginning in 2011.

Withholding, Information Reporting and other Administrative Provisions

- strengthen the rules for foreign financial institutions that are "qualified intermediaries" (QIs), to require that QIs must disclose all of their account holders that are US persons and all reportable payments received on behalf of US persons, with regulatory authority to implement the purposes of the rule (including to provide that a financial institution may be a QI only if all commonly controlled financial institutions are also QIs and to require QIs to collect information indicating the beneficial owners of foreign entity account holders and report if any such beneficial owner is a US person), beginning in the year after enactment;

- require 30% withholding generally for all payments of US-source "fixed or determinable annual or periodical" income to nonqualified intermediaries (subject to Treasury authority to exempt certain entities), and to other non-US entities that do not provide documentation of their beneficial owners or meet one of certain other exceptions (*e.g.*, public companies, foreign governments, pensions funds, and any other entity that Treasury exempts), for payments made beginning in the year after enactment;

- require withholding of 20% of the proceeds of sales of securities to nonqualified intermediaries in jurisdictions that do not have comprehensive treaties with the US including an exchange of information program (subject to Treasury authority to exempt certain payments and entities), for payments made beginning in the year after enactment;

- require information reporting by US financial intermediaries or QIs of money or property worth more than $10,000 transferred to or received from, or the opening of, a foreign bank, brokerage or other financial account (generally other than an account with a QI), in any such case on behalf of a US person, other than a publicly traded company, or an entity controlled by a US person (subject to Treasury authority to provide additional exceptions), for transfers, receipts and accounts opened after December 31 of the year of enactment;

- require information reporting with respect to payments made by all real estate lessors to service providers, beginning in 2010;

- require information reporting with respect to payments to corporations made after December 31, 2009; and

- significantly increase information return penalties, beginning in 2011.

Individual

- return the maximum individual tax rates to 39.6% (for ordinary income) and 20% (for capital gains and dividends), and reinstate the personal exemption and itemized deduction phaseouts, in each case beginning in 2011;

- limit the rate for itemized deductions to 28% for taxpayers with incomes in excess of $200,000 ($250,000 for married couples filing jointly), beginning in 2011;

- require reporting by individuals on their tax returns of transfers of money or property to, or receipts of money or property from, a foreign bank, brokerage or other financial account (other than a QI) if the aggregate value of such transfers and receipts in any year exceeds $10,000, for transfers and receipts occurring after December 31 of the year of enactment;

- require individuals who are required under current law to file “foreign bank account reports” (FBARs) to disclose certain information with respect to the relevant foreign account(s) on their tax returns (in addition to filing the FBAR itself), for tax years beginning after December 31 of the year of enactment; and

- exclude from income tax and AMT 100% of individuals’ and noncorporate taxpayers’ gain from the disposition of qualified small business company stock meeting certain holding period and other criteria, for stock issued after February 17, 2009.

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If you have any questions about the matters covered in this memorandum, please contact your regular Davis Polk contact.

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