

WHITE HOUSE BUDGET PROPOSAL FOR 2011

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Practices & Industries

Business Tax

The Obama administration recently released its General Explanations of the Administration's Revenue Proposals (known as the "Green Book"), which details the Administration's budget proposals for fiscal year 2011. Many of the proposals also appear in recent legislation or are recycled from the Administration's FY 2010 budget proposal. If enacted, the Green Book proposals will affect the federal income tax considerations of individuals and businesses in both the domestic and international contexts. The following is a summary of some of the key Green Book provisions.

Individuals

Increased Taxes for High-Income Individuals. The top two income tax rates, currently 33 percent and 35 percent, would go up to 36 percent and 39.6 percent respectively in 2011. The top bracket, 39.6 percent, would begin at taxable income of about \$375,000 in 2011 and would be indexed for inflation after that. Individuals in the 36 percent and 39.6 percent brackets would be taxed at 20 percent on long-term capital gains and qualifying dividends. All other individuals' long term capital gains and qualifying dividends would be taxed at the current rate (generally 15 percent). In addition, for individuals in the top two brackets, itemized deductions (including charitable contributions) would offset income only at a rate of 28 percent. This would further increase high-income individuals' income tax.

Estate Tax at 2009 Level. The estate tax would be frozen at 2009 levels: an exemption of \$3,500,000 and a 45 percent top rate. This actually represents a tax break for decedents' estates; under current law the 2011 exemption would be much lower, and the 2011 top tax rate would be much higher.

Use of GRATs Restricted. Grantor retained annuity trusts (GRATs) would be required to have a minimum term of 10 years. This would reduce the effectiveness of this popular estate planning device.

Repeated Willful Failure to File a Felony. A taxpayer who willfully fails to file a tax return could be charged with a felony. This crime is currently a misdemeanor.

State and Local Sales Tax Deduction Extended. The current deduction for state and local sales tax would be extended through 2011.

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Carried Interests Taxed as Ordinary Income. A partner who provided services (not capital) to a partnership would be taxed at ordinary income rates on partnership income that otherwise would be taxed at long-term capital gains rates. Income flowing through to a “service partner” from the partnership, moreover, would be subject to self-employment taxes.

Businesses

Bonus Depreciation Etc. Businesses could claim a first-year bonus depreciation deduction equal to 50 percent of the cost of qualifying property placed in service in 2010. Cell phones would no longer be subject to depreciation limitations or strict standards for substantiation of business use. Current generous limits on the cost of depreciable property that can be deducted (rather than capitalized and depreciated) would be extended through 2010. Non-corporate taxpayers would not be taxed on gain from the sale of “qualified small business stock” in certain situations.

Credit for New Hires. A tax credit of up to \$5,000 would be available to small businesses that add new workers in 2010.

Big Banks Pay for TARP. Certain large financial institutions would be subject to a new tax intended to pay for the government bailout (the Trouble Asset Relief Program).

Energy Industry Changes. Additional funding would be dedicated to the new credit for advanced energy manufacturing projects. This credit, introduced last year, is intended to encourage investment in facilities that manufacture advanced energy property. At the same time, many longstanding tax breaks for producers of oil and gas and coal would be eliminated.

Research Credit and New Markets Credit. The research and experimentation credit, which expired December 31, 2009, would be permanently reinstated. The new markets tax credit for qualified equity investments in a “community development entity,” which also expired last year, would be extended through 2011.

Repeal of Advantageous Inventory Methods. The “last in first out” (LIFO) inventory method could no longer be used for federal tax purposes. Nor could businesses use “lower of cost or market” in determining inventory for federal tax purposes.

International

Limiting Foreign Tax Credits (FTCs). A “matching rule” would be imposed so that a FTC would only be allowed “when and to the extent the associated foreign income is subject to U.S. tax in the hands of the taxpayer claiming the credit.” Also, indirect FTCs would be determined on a consolidated basis for all foreign subsidiaries and would only be creditable to the extent of repatriated consolidated earnings and profits of the foreign subsidiaries.

Deferral of Interest Deductions. Companies would be required to defer and carry forward interest deductions that are allocated and apportioned to foreign-source income until the foreign-source income is subject to U.S. tax in a later year.

Reducing Inverted Entities’ Interest Deductions. “Expatriated entities” (other than surrogate foreign corporations) would be subject to stricter interest-stripping rules, including an elimination of a debt-to-equity safe harbor (which is otherwise 1.5:1). There would also be a reduction of the amount of deductible “disqualified interest” an expatriated entity pays to related parties to 25 percent (rather than 50 percent) of adjusted taxable income. This rule would apply as though the

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current rules applicable to expatriated entities (IRC § 7874) were in effect beginning July 10, 1989.

Increased Reporting of Offshore Accounts and Entities. To combat U.S. taxpayers' use of foreign entities and accounts to hide assets or evade U.S. taxes, with respect to the receipt of U.S.-source interest, dividends, and similar income (including proceeds from the sale of property producing such income), the Qualified Intermediary program would essentially be mandatory for foreign financial institutions (FFIs), including investment and hedge funds. Non-FFI foreign entities receiving U.S.-source income would be required to report U.S. owners to the IRS. In either case, failure to comply with the rules would result in 30 percent U.S. tax withholding on the U.S.-source payments to the entity.

Increased Reporting of Foreign Financial Assets. Taxpayers would be required to disclose more detailed information about foreign financial assets on income tax returns, in addition to the separate FBAR filing, if the aggregate value of such assets exceeds \$50,000. Taxpayers would also be required to report transfers to and from non-U.S. financial accounts of at least \$50,000 in the aggregate.

Penalties and Statute of Limitations. The current 20 percent accuracy-related penalty imposed on certain understatements of income would double to 40 percent when the understatement is related to a failure to disclose foreign financial assets. Omissions from gross income of more than \$5,000 attributable to certain undisclosed foreign financial assets would result in a six-year statute of limitations period rather than three.

No Check-the-Box Reform. Notably, the Administration has dropped the controversial check-the-box proposal that would have disallowed an election by a foreign eligible entity to be disregarded from its single owner for U.S. tax purposes unless that owner was created or organized in the same foreign country as the foreign-eligible entity.

Conclusion

While it remains to be seen which of these proposals will ultimately be enacted, either as part of the 2011 budget or in other legislation, the Green Book provides valuable insight into the tax policy objectives of the administration and the tax agenda for Congress to address in the coming weeks and months.

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