ORRICK

The Obama Administration's Fiscal Year 2012 Revenue Proposals

On February 14, 2011, the Obama Administration Fiscal Year 2012 Budget and the Department of the Treasury "General Explanations of the Administration's FY2012 Revenue Proposals" (the "Budget") were released. Although the proposed statutory changes in the Budget are unlikely to be approved in full without revision, the Budget contains key provisions related to investments in innovation and infrastructure, reforms of the treatment of financial institutions and products, and reforms of international tax rules.

As discussed in greater detail below, the Budget includes provisions for:

- Additional tax credits for investment in advanced energy manufacturing projects.
- Tax credits for energy-efficient commercial buildings.
- Expanding the research and experimentation credit and making it permanent.
- Permanently eliminating capital gains taxes for investments in certain qualified small businesses.
- Creation of a Financial Crisis Responsibility Fee.
- Requiring accrual of income on certain forward sales of corporate stock.
- Require ordinary treatment of income from day-to-day dealer activities for certain dealers of equity options and commodities.
- Deferring deduction of interest expense related to foreign-source deferred income.
- Determining foreign tax credits on a pooling basis.
- Current taxation of excess returns associated with transfers of intangibles offshore.
- Limiting shifting of income through intangible property transfers.

Tax Incentives to Support Innovation and Infrastructure

- Renew the Advanced Energy Manufacturing tax credit.
- Provide a tax credit, rather than a deduction, for energy efficient commercial building property.
- Make the Research and Experimentation tax credit permanent.
- Make the capital gains tax exemption for non-corporate investments in qualified small businesses permanent.

Tax Credits for Investment in Advanced Energy Manufacturing Projects.

The American Recovery and Reinvestment Act of 2009 ("ARRA"), created Code Section 48C, which established a 30% tax credit for investments in eligible property used in a qualifying advanced energy project. A qualifying advanced energy project is a project that re-equips, expands, or establishes a manufacturing facility for the production of:

(1) property designed to produce energy from renewable resources;
(2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric vehicles;
(3) electric grids to support the transmission, including storage, of

intermittent sources of renewable energy;

(4) property designed to capture and sequester carbon dioxide emissions;
(5) property designed to refine or blend renewable fuels or to produce energy conservation technologies;
(6) electric drive motor vehicles that qualify for tax credits or components designed for use with such vehicles; and
(7) other advanced energy property designed to reduce greenhouse gas emissions.

ARRA provided $2.3 billion to grant credits, which funded less than one-third of the technically acceptable applications submitted.

The Budget proposes to provide $5 billion in additional authority to grant tax credits under Code Section 48C. The $5 billion in additional tax credits will support at least $15 billion in total capital investments. The proposal would be effective on the date of enactment..

Tax Credits for Energy-Efficient Commercial Buildings.

Under current law, Code Section 179D permits taxpayers to deduct expenditures for certain energy efficient commercial building property. In the case of a building that does not achieve a specified level of energy savings, a partial deduction is allowed with respect to each separate building system (e.g., interior lighting) that meets a prescribed system-specific energy-savings target.

The Budget proposes replacing the current tax deduction for energy efficient commercial building property under Code Section 179D with a more generous and effective tax credit that will encourage building owners to retrofit their properties. The proposal would also allow a partial credit for achieving less stringent efficiency standards. In addition, the proposal would treat property as meeting certain energy savings requirements if specified prescriptive standards are satisfied, reducing the complexity of the current standards, which require whole-building auditing, modeling, and simulation. Special rules would be provided that would allow the credit to benefit a REIT or its shareholders. The new tax credit would be available for property placed in service during calendar year 2012.

Expanding the Research and Experimentation Credit and Making it Permanent.

Under current law, Code Section 41 provides a Research and Experimentation ("R&E") tax credit for qualified research expenses above a base amount. A taxpayer must choose between using an outdated formula for calculating the R&E tax credit that provides a 20% credit rate for research spending over a certain base amount related to the business's historical research intensity and the much simpler alternative simplified credit method ("ASC") that provides a 14% credit for research expenses in excess of a base amount based on its recent research spending. The credit is scheduled to expire at the end of 2011.

The Budget proposes making the R&E tax credit permanent and increasing the rate of the ASC to 17%. The proposal would be effective after December 31, 2011. Similar proposals were contained in the Administration's FY2009, FY2010, and FY2011 budgets.

Permanently Eliminate Capital Gains Taxes for Investments in Certain Qualified Small Businesses.

The Budget would increase permanently to 100% the exclusion for qualified small business stock sold by an individual or other non-corporate taxpayer and would eliminate the AMT preference item for gain excluded under this provision. As under current law, the stock would have to be held for at least five years and other limitations on the exclusion would continue to apply. The proposal would include additional documentation requirements to assure compliance with those limitations and taxpayers would be required to report qualified sales on their tax returns. The proposal would be effective for qualified small business stock acquired after December 31, 2011. Similar proposals were contained in the Administration's FY2010 and FY2011 budgets.

Reform of Treatment of Financial Institutions and Products

- Create a Financial Crisis Responsibility fee assessed at 7.5 basis points on "covered liabilities" of certain U.S. financial institutions.
- Require accrual of interest income required for a corporation that enters into a forward contract to issue its stock.
- Require ordinary treatment of income required for certain dealers of Code Section 1256

Creation of a Financial Crisis Responsibility Fee.

The Budget includes a revised version of the Obama Administration's proposed Financial Crisis Responsibility Fee. The law that created the Troubled Asset Relief Program ("TARP") requires the President to propose an assessment on the financial sector to pay back the costs of these extraordinary actions. The Financial Crisis Responsibility Fee would be assessed on certain liabilities of the largest firms in the financial sector. Specific components of the proposal include:

- *Firms Subject to the Fee*: The fee would apply to U.S.-based bank holding companies, thrift holding companies, certain broker-dealers, companies that control certain broker-dealers and insured depository institutions. U.S. companies owning and controlling these types of entities as of January 14, 2010 also would be subject to the fee. Firms with worldwide consolidated assets of less than $50 billion would not be subject to the fee for the period when their assets are below this threshold. U.S. subsidiaries of foreign firms that fall into these categories and that have assets in excess of $50 billion also would be covered.
- *Base of Fee*: The fee would be based on the covered liabilities of a financial firm. Covered liabilities are generally the consolidated risk-weighted assets of a financial firm, less its capital, insured deposits, and certain loans to small business. These would be computed using information filed with the appropriate Federal or State regulators.
- *Fee Rates*: The rate of the fee applied to covered liabilities would be approximately 7.5 basis points per annum. A discount would apply to more stable sources of funding, including long-term liabilities.

- *Deductibility*: The fee would be deductible in computing corporate income tax.
- *Filing and Payment Requirements*: A financial entity subject to the fee would report it on its annual Federal income tax return. Estimated payments of the fee would be made on the same schedule as estimated income tax payments.

The fee would be effective as of January 1, 2013. A similar proposal, which would have assessed the fee at 15 basis points, was contained in the Administration's FY2011 budget. Addressing the FY2011 proposed fee, the Congressional Budget Office ("CBO") estimated there were approximately 60 bank holding and insurance companies with assets in excess of the $50 billion threshold that comprised most of the institutions that would be likely to pay the fee. The CBO predicted the fee would probably lower the total supply of credit in the financial system to a slight degree and slightly decrease the availability of credit for small businesses.

<u>Require Accrual of Income on Certain Forward Sales of Corporate Stock</u>.

Under current law, a corporation generally does not recognize gain or loss on the issuance or repurchase of its own stock, including gain or loss on the forward sale of its own stock. On the other hand, a corporation does recognize interest income upon the current sale of any stock (including its own) for deferred payment.

The Budget proposal would require 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. The proposal would be effective for forward contracts entered into after December 31, 2011. Similar proposals were contained in the Administration's FY2010 and FY2011 budgets.

<u>Require Ordinary Treatment of Income From Day-To-Day Dealer Activities for Certain Dealers of Equity Options and Commodities</u>.

Under current law, Code Section 475 permits certain dealers to treat the income from some of their day-to-day dealer activities as capital gain. This special rule applies to certain transactions in Code Section 1256 contracts by dealers in commodities, commodities derivatives, securities, and options. Currently under Code Section 1256, these dealers treat 60% of their income (or loss) from their dealer activities in Code Section 1256 contracts as long-term capital gain (or loss) and 40% of their income (or loss) from these dealer activities as short-term capital gain (or loss). Dealers in other types of property generally treat the income from their day-to-day dealer activities as ordinary income.

The Budget proposal would require dealers in commodities, commodities derivatives, securities, and options to treat the income from their day-to-day dealer activities in Code Section 1256 contracts as ordinary in character, not capital. The proposal would be effective for taxable years beginning after the date of enactment. Similar proposals were contained in the Administration's FY2010 and FY2011 budgets.

ORRICK

Reform of International Tax Rules

- Require deferral of the deduction of interest expense allocated to deferred foreign-source income.
- Require determination of deemed paid foreign tax credit to be made on a consolidated basis.
- Treat certain income from transfers of an intangible from the United States to a related CFC treated as subpart F income.
- Expand definition of intangible property and the valuation of intangible properties for certain transfers for purposes of Code Sections 367(d) and 482.

Defer Deduction of Interest Expense Related to Foreign-Source Deferred Income. Taxpayers generally may deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business. Under current law, a U.S. person that incurs interest expense properly allocable and apportioned to foreign-source income may deduct those expenses even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. For purposes of the U.S. foreign tax credit rules, a U.S. person may be required to recapture as U.S.-source income the amount by which foreign-source expenses exceed foreign-source income for a taxable year. However, if in a taxable year the U.S. person earns sufficient foreign-source income of the same statutory grouping, expenses (such as interest expense) properly allocated and apportioned to the foreign-source income may not be subject to recapture in a subsequent taxable year.

The Budget proposal goes further by requiring the deferral of any interest expense deduction that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax. For purposes of the proposal, 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 subsequent tax year. The proposal would be effective for taxable years beginning after December 31, 2011. A similar proposal was contained in the Administration's FY2011 budget. A broader proposal to defer a deduction for all expenses other than research and experimentation expenditures was contained in the Administration's FY2010 budget.

Determine the Foreign Tax Credit on a Pooling Basis. Under current law, Code Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for certain foreign taxes paid or accrued during the taxable year. Under Code Section 902, a domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the "deemed paid foreign tax credit"). The foreign tax credit is limited and this limitation is applied separately to foreign-source income in each of the separate categories described in Code Section 904(d)(1), that is, the passive category and general category. In 2010, two significant changes were made to the foreign tax credit rules with the adoption of Code

Section 909, relating to foreign tax credit splitting events, and Code Section 901(m), relating to covered asset acquisitions and designed to address perceived flaws in the foreign tax credit formula following an acquisition.

The Budget proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis based on the 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 certain lower tier subsidiaries). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year. The proposal would be effective for taxable years beginning after December 31, 2011. Similar proposals were contained in the Administration's FY2010 and FY2011 budgets.

<u>Tax Currently Excess Returns Associated With Transfers of Intangibles Offshore</u>.
Under current law, Code Section 482 provides that, in the case of transfers of intangible assets, the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets. In general, the subpart F rules (Code Sections 951 through 964) require U.S. shareholders with a 10% or greater interest in a controlled foreign corporation ("CFC") to include currently in income for U.S. tax purposes their pro rata share of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is actually distributed to the shareholders. A foreign tax credit is generally available for foreign income taxes paid by a CFC to the extent that the CFC's income is taxed to a U.S. shareholder under subpart F, subject to the limitations set forth in Code Section 904.

The Budget proposal would provide that if a U.S. person transfers an intangible from the United States to a related CFC (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. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with or benefitting from such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up. For purposes of this proposal, the transfer of an intangible includes by sale, lease, license, or through any shared risk or development agreement (including any cost sharing arrangement). This subpart F income will be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under Code Section 904. The proposal would be effective for transactions in taxable years beginning after December 31, 2011. A similar proposal was contained in the Administration's FY2011 budget.

<u>Limit Shifting of Income Through Intangible Property Transfers</u>.
Under current law, Code Section 482 provides that, in the case of transfers of intangible assets, the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets. Under Code Section 367(d), if a U.S. person transfers intangible property to a foreign corporation in certain nonrecognition transactions, the U.S. person

ORRICK

is treated as selling the intangible property for a series of payments contingent on the productivity, use, or disposition of the property that are commensurate with the transferee's income from the property. The payments generally continue annually over the useful life of the property. Controversy has arisen concerning the value of intangible property transferred between related persons and the scope of the intangible property subject to Code Sections 482 and 367(d).

The proposal would clarify the definition of intangible property for purposes of Code Sections 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal also would clarify that where multiple intangible properties are transferred, the IRS may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the IRS may 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. The proposal would be effective for taxable years beginning after December 31, 2011. Similar proposals were contained in the Administration's FY2010 and FY2011 budgets.

For additional information, please contact:

Grady M. Bolding
415-773-5716

Colman J. Burke
415-773-5608

Peter J. Connors
212-506-5120

Stephen J. Jackson
+33 1 5353 8111

Steven C. Malvey
415-773-5647

John Narducci
212-506-5105

Greg R. Riddle
415-773-5533

George G. Wolf
415-773-5988

James M. Larkin
212-506-5256

Stephen C. Lessard
212-506-5137

Eric C. Wall
415-773-5974