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# Client Alert

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## THE OBAMA ADMINISTRATION'S TAX PROPOSALS

On Monday, May 11, the Obama Administration released its General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (Greenbook), generally describing the tax law changes the Administration will propose to Congress. Although, it is impossible to gauge how responsive Congress will be to any of the proposals, many represent significant shifts from current tax policies or practices and could affect taxpayers' businesses. Because no specific statutory language has yet been drafted, our discussion of several key proposals must be general in nature. Please note that, in addition to the proposals described below, the Administration proposed fundamental changes to the U.S. international tax regime, which we describe in a separate client alert that is available on our website (click [here](#) to view).

### Codification of the Economic Substance Doctrine

The Administration proposes codifying the "economic substance doctrine" and imposing a new penalty scheme for certain transactions that lack economic substance. The stated goal is to standardize the application of the doctrine across all jurisdictions and to deter taxpayers from entering into transactions that lack economic substance. The economic substance doctrine is a common law doctrine often invoked by the IRS that denies taxpayers the tax benefits associated with a transaction that lacks economic substance. Different courts have applied different criteria in determining whether a transaction has or lacks economic substance, including examining whether (1) the transaction meaningfully changes the taxpayer's economic position (other than federal tax effects) and (2) the taxpayer has a substantial purpose for entering into the transaction (other than a federal tax purposes).

The proposal would clarify that a transaction has economic substance only if it satisfies both criteria described in the preceding paragraph. A transaction would not be treated as having economic substance because of a profit potential unless the present value of the expected pre-tax profit is substantial in relation to the present value of the expected federal tax benefits. If a transaction lacks economic substance, the taxpayer will be subject to a penalty equal to 30% of its understatement of tax attributable to the transaction, which would be reduced to 20% in cases where the taxpayer has disclosed the relevant facts on its tax return. The penalty would be

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imposed in lieu of other accuracy related penalties applicable when a taxpayer has substantially understated its income (generally, 20% of the understatement). The IRS would be given general authority to impose the penalty, even without a court determination that a transaction lacks economic substance, and limited authority to abate a penalty. In addition to the 30% penalty, taxpayers would not be allowed a deduction for interest attributable to any understatement of tax resulting from a subject transaction. The proposal grants the Treasury authority to issue regulations to carry out the purposes of the proposal.

The codified economic substance doctrine and related penalties would be applicable to transactions entered into after the enactment of the law and the denial of interest deductions would be applicable in tax years ending after the date of enactment for transactions entered into after the date of enactment.

### Repeal of LIFO

The Administration proposes repealing last-in, first-out (LIFO) accounting for inventory. LIFO accounting allows a taxpayer computing the value of its inventory and cost of goods sold to treat the most recently acquired goods as having been sold first. LIFO accounting is generally valuable for companies with increasing inventory costs. The proposal would be effective for a taxpayer's first taxable year beginning after December 31, 2011. The increased income resulting from the change would be recognized ratably over the first tax year the change is applicable and the following seven tax years.

### Taxation of Carried Interest as Ordinary Income

The Administration proposes taxing income or gain attributable to a service provider's carried interest or profits interests in a partnership as ordinary income. Under current law, a service provider that receives a carried interest in a partnership in exchange for services can treat the income received with respect to that interest as having the same character as it has at the partnership level. This means that a service partner's share of gain realized on the partnership's sale of capital assets, including stock and securities, will generally be treated as capital gain to the service provider and accordingly taxed at lower capital gains rates and not subject to self-employment taxes (Social Security and Medicare).

The Administration's proposal is to treat a partner's share of income from a "service partnership interest" (SPI) as ordinary income subject to self-employment taxes, regardless of its tax character at the partnership level. Gain on the sale of an SPI itself would also generally be taxed as ordinary income. An SPI is defined as a carried interest held by a person who provides services to the partnership. A service provider would not be subject to this regime on any partnership income allocable to the portion of the partner's interest that was acquired in exchange for a capital investment in the partnership. As a backstop anti-abuse rule, certain interests will not count as capital investments, such as interests purchased with contributed capital that was loaned, advanced or guaranteed by any partner or the partnership or interests in, convertible or contingent debt, options or derivative instruments.

The proposal would be effective for tax years beginning after December 31, 2010.

### Expansion of NOL Carryback Period

One of the taxpayer favorable proposals in the Greenbook is an extension of the period that a company can carry back its net operating losses (NOLs) to offset income earned in prior years. Under current law, an NOL generally may be carried back to offset income earned up to two tax years prior to the tax year the NOL is generated and may be carried forward for up to twenty years. The Administration proposes working with Congress to extend the carry-back period beyond two years. Under the recent stimulus legislation, the carry back period was extended to five years for NOLs generated in 2008 and 2009 by certain small businesses with less than \$15 million of gross receipts. A bill has been introduced in the Senate to extend the NOL carryback period for 2008 and 2009 NOLs for **all** corporations to five years. The Administration and Congress may also consider allowing the carryback of losses to fully offset alternative minimum taxable income (AMTI) arising during the extended carryback period; currently, NOLs can only offset up to 90% of AMTI.

### Elimination of Capital Gains on Investments in Small Business Stock

Another taxpayer favorable provision in the Greenbook is the proposal eliminating the capital gains tax for non-corporate shareholders on the sale of stock of certain small business corporations. Current law allows non-corporate shareholders to exclude from taxable income 50% (up to 75% in certain circumstances) of the gain from the sale of stock in certain small business corporations if the stock was acquired by the shareholder in the original issuance and held for at least 5 years. A portion of the excluded gain may, however, be subject to alternative minimum tax (AMT). There is also a limit on the maximum exclusion of gain equal to the greater of (i) ten times the holder's tax basis in its stock and (ii) \$10 million. For capital gain to be excludable, the small business corporation must be a domestic C corporation that had gross assets of not more than \$50 million on the date it issued the relevant stock. The C corporation must be engaged in an active business and may not be (i) a services corporation where the principal asset is the reputation or skill of employees, (ii) a financial services, leasing, banking or other similar business, (iii) a business involving the production or extraction of an item subject to depletion or (iv) a hotel, motel, restaurant or similar business.

The Administration proposes to expand the exclusion of gain attributable to the sale of small business stock to 100% of gains. The Administration also proposes to exempt any such gains from the AMT. The limitations regarding the amount of gain, holding period for the stock and business of the corporation would not change.

The proposal would be effective for stock in a small business corporation purchased after February 17, 2009.

### Make the Research and Experimentation Tax Credit Permanent

The Research and Experimentation (R&E) Tax Credit provides a credit for a portion of a taxpayer's increased R&E expenditures. The R&E Tax Credit is a temporary credit, the availability of which has been regularly extended by Congress. In many prior years, the expiration date of the R&E Tax Credit was not extended until shortly before the credit was scheduled to expire. The Administration believes that the temporary nature of the R&E Tax Credit makes it difficult for taxpayers to rely on the credit in planning their long term R&E activity levels. The Administration is proposing to make the R&E Tax Credit permanent.

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