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Client Alert

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New Tax Proposals in the Tax Reduction and Reform Act of 2007

By Drew Batkin

On Thursday, October 25, 2007, Congressman Rangel, the Chairman of the House of Representatives Ways and Means Committee introduced the Tax Reduction and Reform Act of 2007 (the "Bill"). The Bill proposes ambitious individual and corporate tax changes. The Bill is not anticipated to be considered by the House of Representatives until at least 2008, but many of its provisions mark broad policy shifts and could be indicative of changes to come. Additionally, some of the more time sensitive sections of the Bill, such as the one year Alternative Minimum Tax (AMT) "patch" and the extension of the R&D credit are likely to be added to more timely legislation.

The Bill has generated significant condemnation from House of Representatives and Senate Republicans, and the

Democratic leadership has similarly indicated it does not support the plan as a whole. However, to facilitate following the important and ongoing dialogue concerning tax policy, we have prepared this description of the Bill's most significant corporate tax proposals.

In addition to the corporate tax proposals described below, the Bill's hallmark provisions include (i) the permanent repeal of the individual AMT, which, while originally designed to ensure that the wealthiest taxpayers pay a minimum tax rate ensnares a consistently increasing number of "middle class" taxpayers; (ii) the taxation of investment managers' "carried interest" at ordinary rather than capital gains rates; and, (iii) for individual filers whose adjusted gross income exceeds a threshold amount (not to be less than \$200,000), a 4% surtax on adjusted gross income over that threshold and an additional .6% on

adjusted gross income in excess of \$250,000.

DOMESTIC PROVISIONS

Reduction in the Corporate Tax Rate. The Bill proposes cutting the corporate tax rate to 30.5% from 35%. The cost of this considerable cut is offset through various revenue raising measures.

Repeal of Last-in, First-out (LIFO) Accounting Method. The Bill would repeal the last-in, first-out (LIFO) accounting method. Any income recognized as a result of this change in accounting method would be spread over eight years.

Amortization of Intangibles. The Bill extends the period over which intangibles are amortized from 15 years to 20 years.

Modifications to Deductions for Dividends Received. The Bill would reduce the deduction for dividends

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received. In the case of 20-percent or more owned corporations, the current-law 80% dividends received deduction will be reduced to 70%. Dividends that are currently eligible for a 70% dividends received deduction would instead be eligible for a 60% deduction.

Repeal of the Section 199 Deduction. The Bill would repeal the section 199 domestic production activities deduction, which was added by the Jobs Creation Act of 2004 and is still being phased in. The domestic production activities deduction generally allows a taxpayer to deduct from its taxable income an amount equal to the lesser of its income from the manufacture, production, growth, or extraction of certain property by the taxpayer in whole or in significant part within the U.S. or its taxable income for the taxable year. Income that generally qualifies under this deduction includes net income from (1) producing tangible personal property, certain sound recordings, certain films, electricity, natural gas, and potable water, and (2) real property construction, and architectural and engineering services performed in connection with real property construction. Chairman Rangel's release labels the Section 199 deduction administratively burdensome and limited to only a select stream of corporate income.

Clarification of Gain Recognized in certain Spin-off Transactions. The Bill would treat distributions of debt securities in a tax free spin-off transaction in the same manner as distributions of cash or other property. Under current law, taxes are generally imposed on parent corporations where they extract cash or other property in excess of basis from their subsidiaries prior to engaging in a tax free spin-off transaction. However, currently taxes are not assessed if a subsidiary corporation distributes its own debt securities to a parent corporation prior to a spin off transaction even where the value of these securities would exceed the parent corporation's basis in its subsidiary. This provision aims to tax such debt distributions.

Clarification of the Economic Substance Doctrine. The Bill intends to clarify the application of the economic substance doctrine but not to change current-law standards used by courts in determining when to utilize an economic substance analysis. Under the proposal, in any case in which a court determines that the economic substance doctrine is relevant to a transaction, a transaction would satisfy the economic substance doctrine requirements only if (1) the transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax

consequences), and (2) the taxpayer has a substantial purpose (apart from federal income tax consequences) for entering into such transaction. The provision also imposes a 20% penalty on understatements attributable to a transaction lacking economic substance (the penalty is increased to 40% in the case of transactions in which the relevant facts affecting the tax treatment of the transaction are not adequately disclosed). This provision is very similar to a provision recently passed by the Senate Finance Committee.

FOREIGN RELATED PROVISIONS

Allocation of expenses and taxes on basis of repatriation of foreign income. Current law allows U.S. corporations to defer active business income that is earned through controlled foreign corporations. However, these U.S. corporations may generally take deductions associated with this income into account on a current basis. The Bill would require U.S. corporations that defer income through controlled foreign corporations to also defer the deductions associated with this income. These U.S. corporations will be able to recognize these deductions when they repatriate the deferred income back to the U.S., which is generally when the deferred income is taxed.

Repeal of Worldwide Allocation of Interest. The Bill would repeal the current-law allowing U.S. corporations to elect special interest allocation rules that reduce the amount of interest expense allocated to foreign assets, which increases the interest deduction against U.S. income. The current-law provision was enacted in 2004 but it has yet to take effect.

Limitation on Treaty Benefit for Certain Deductible Payments. The Bill would reduce potential tax treaty benefits available to a U.S. subsidiary that makes deductible payments (such as interest and royalties) to a related foreign treaty eligible company that in turn forwards those payments to a parent company in a tax haven country (i.e., a non-treaty partner country). This provision generally imposes withholding on the U.S. source deductible payments at the rate applicable to payments made directly to companies in the tax haven country (generally the 30% statutory rate) rather than at the reduced rate applicable to payments made to companies in the treaty partner country. A similar, but broader, provision was passed in July by the House of Representatives as part of its Farm Bill, which is currently awaiting deliberation in the Senate.

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