

February 2, 2010

# Presidential Fiscal Year 2011 Revenue Proposals

---

## President Releases Fiscal Year 2011 Corporate and Partnership Taxation Proposals

---

### SUMMARY

On February 1, 2010, the Obama Administration (the "Administration") released the General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (commonly known as the "Green Book"). Although the Green Book does not include proposed statutory language, the Green Book contains significant detail about the fiscal year 2011 budget proposals. If enacted, the proposals contained in the Green Book would affect many aspects of U.S. federal income taxation, including individual, corporate, partnership and international taxation. This memorandum discusses key aspects of the Green Book that relate to corporate and partnership taxation. We are concurrently distributing separate memoranda addressing Green Book proposals affecting (1) individual, estate and gift taxation and (2) international taxation that we anticipate may be of interest to our clients, and which may be obtained by following the instructions at the end of this memorandum.

In regards to corporate and partnership taxation, the Green Book would (1) impose a Financial Crisis Responsibility Fee on large financial firms, (2) tax carried interests as ordinary income and as net earnings from self-employment, (3) codify the economic substance doctrine, (4) repeal the last-in, first-out and the lower-of-cost-or-market inventory accounting methods, (5) modify the treatment of certain reorganizations, (6) require income to be accrued on the forward sale of a corporation's own stock, (7) require certain dealers of derivatives and commodities to treat all income earned through such activities as ordinary, (8) expand the definition of "control" for purposes of disallowing or limiting an issuer's deduction for a premium paid to repurchase a debt instrument that is convertible into its own stock, or into stock of a corporation in control of or controlled by the issuer, (9) limit the dividends-received deduction

## SULLIVAN & CROMWELL LLP

for life insurance company separate accounts, (10) expand the disallowance of interest deductions for corporate-owned life insurance contracts, (11) repeal certain oil and gas company preferences, (12) disallow deductions for punitive damages, (13) extend temporary bonus depreciation for certain property, (14) eliminate the classification of cell phones as listed property, (15) extend the statute of limitations for federal tax liabilities in certain situations, (16) require reporting of payments by rental income recipients to service providers, (17) require information reporting for private separate accounts of life insurance companies and (18) require information reporting on payments to corporations and electronic filings by certain large organizations. The Green Book would also provide several tax reductions for businesses by (1) eliminating capital gains taxation on investment in small business stock, (2) making the research and experimentation tax credit permanent and (3) extending certain expiring provisions through calendar year 2011. Unlike the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals<sup>1</sup> (the "2009 Green Book"), the current Green Book does not express any desire on the part of the Administration to work with Congress to expand the net operating loss carryback period for businesses other than certain eligible small business.

---

## DISCUSSION

### A. REVENUE PROVISIONS

#### 1. Imposition of a Financial Crisis Responsibility Fee

The Green Book would impose a Financial Crisis Responsibility Fee at a rate of "approximately" 15 basis points on certain liabilities of the largest firms in the financial sector. This aspect of the Green Book was first announced in a speech by the President on January 14, 2010. The fee would be applied to banks, thrifts, bank and thrift holding companies, brokers and securities dealers as well as U.S. companies owning or controlling these types of entities as of January 14, 2010. Firms with consolidated assets of less than \$50 billion would not be subject to the fee for the period when their assets are below this threshold. The Green Book explains that the fee is designed to "provide a deterrent against excessive leverage for the largest financial firms" and to satisfy the statutory requirement of the Troubled Asset Relief Program ("TARP") requiring the President to propose an assessment on the financial sector to pay back the costs of TARP.

In general, the assessable base of the fee would include the worldwide consolidated liabilities of U.S. financial firms. Financial firms not based in the United States would be subject to the fee on the liabilities of their U.S. subsidiaries. The fee base would include a broad set of liabilities with a few designated

---

<sup>1</sup> A further discussion of the 2009 Green Book can be found in the Sullivan & Cromwell LLP Publication entitled "Presidential Proposal on International Taxation: President Releases Fiscal Year 2010 International Taxation Proposals" (May 15, 2009), which may be obtained by following the instructions at the end of this publication.

## SULLIVAN & CROMWELL LLP

exceptions, such as FDIC-assessed deposits of firms that own depository institutions and certain policy-related liabilities of insurance companies. Covered liabilities would be determined using the balance sheet information filed with the appropriate federal or state regulators. The Green Book also states that adjustments would be provided to prevent avoidance and appropriately treat less risky activities, such as lending against certain high quality collateral (presumably repurchase transactions). This aspect of the Green Book would be effective as of July 1, 2010, with the result that calendar year taxpayers would pay the fee with respect to two quarters of the year when filing their returns for 2010.

### **2. Taxation of Carried Interests as Ordinary Income and as Net Earnings from Self-Employment**

Carried interests are typically interests in partnership profits granted to the managers or sponsors of a partnership. Carried interests may be granted without an obligation to invest capital, or with interests in profits that are significantly disproportionate to contributed capital. Although the term “carried interest” generally refers to an interest in a fund, such as a private equity fund, hedge fund or real estate fund, partnerships that operate a single business or project may also issue carried interests to their sponsors or managing members. Under current law, carried interests are generally considered “profits interests”<sup>2</sup> in the partnerships, and the character of income from the partnership flows through to the holders of the carried interests.<sup>3</sup> As a result, capital gains, as well as some items of interest and dividend income of a partnership that are allocated to a carried interest, retain their character and are not considered net earnings from self-employment for purposes of the Federal Insurance Contributions Act (“FICA”). Additionally, because a carried interest is a partnership interest, gain recognized on the sale of a carried interest is generally treated as capital gain except to the extent such gain is attributable to the inventory or unrealized receivables of the Partnership.<sup>4</sup>

Following several previous congressional proposals,<sup>5</sup> the Green Book would generally characterize income derived from, and gain upon the sale of, a “services partnership interest” as ordinary income, regardless of the character of the income or assets at the partnership level. The Green Book would define a “services partnership interest” as “a carried interest held by a person who provides services to the partnership.” An exemption from “services partnership interest” status would apply to the extent a partner contributes “invested capital” and the partnership “reasonably” makes an allocation of income and loss between the carried interest and the capital interest. “Invested capital” would not include loans or

---

<sup>2</sup> A profits interest is an interest in a partnership that does not have any current liquidation value at the time of receipt. See Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>3</sup> Section 702(b). Unless otherwise indicated, all references to “Section” in this memorandum are to the Internal Revenue Code of 1986, as amended.

<sup>4</sup> See Section 751.

<sup>5</sup> See, e.g., H.R. 2834, 110th Cong. (2007).

## SULLIVAN & CROMWELL LLP

advances guaranteed by any partner or the partnership. The Green Book would also treat any income or gain from a “service partnership interest” as net earnings from self-employment for FICA purposes, and thus subject to Social Security and Medicare tax. The Green Book indicates that the Administration does not intend this aspect of the Green Book to have an adverse impact on the ability of an entity that owns a carried interest in a real estate partnership to qualify as a real estate investment trust.

Additionally, the Green Book would include an anti-avoidance rule intended to prevent the Green Book’s carried interest provisions from being circumvented through non-partnership compensatory arrangements. Under the Green Book’s anti-avoidance rule, any person who performs services for an entity and holds a “disqualified interest” in the entity (including a convertible or contingent debt instrument, an option and a derivative) would also be subject to ordinary income tax on any income or gain received with respect to the disqualified interest.

The Green Book’s provisions affecting carried interests would take effect for taxable years beginning after December 31, 2010.<sup>6</sup> The Green Book does not address whether pre-existing arrangements will be grandfathered.

### 3. Codification of the Economic Substance Doctrine

The “economic substance” doctrine has long been applied by courts and the IRS to disallow certain aspects or consequences of tax-motivated transactions that may technically satisfy the requirements of the Internal Revenue Code of 1986, as amended (the “Code”). As a common law doctrine, however, “economic substance” is not uniformly interpreted through the federal judicial system. Some circuit courts apply the so-called “conjunctive test,” which requires that a transaction both (1) objectively have economic consequences to the taxpayer independent of tax benefits and (2) be motivated by a subjective business purpose.<sup>7</sup> Other circuit courts apply a so-called “disjunctive test,” under which a transaction lacks economic substance only if it both (1) objectively lacks economic effect and (2) lacks a subjective business motivation.<sup>8</sup> Still other courts consider objective economic substance and subjective business

---

<sup>6</sup> A similar, although narrower, provision is contained in the Tax Extenders Act of 2009 (the “Extenders Bill”), which the House of Representatives passed on December 9, 2009. See Tax Extenders Act of 2009, H.R. 4213, 111th Cong. (2009).

<sup>7</sup> See, e.g., *Pasternak v. Comm’r*, 990 F.2d 893, 898 (6th Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction . . . . If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made.”).

<sup>8</sup> See, e.g., *Rice’s Toyota World, Inc. v. Comm’r*, 752 F.2d 89, 91 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering into the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.”).

## SULLIVAN & CROMWELL LLP

purpose to be only two factors in a general investigation into whether a transaction has economic effects other than tax benefits.<sup>9</sup>

The Green Book would codify the economic substance doctrine using the “conjunctive test.” Specifically, a transaction would have economic substance under the Green Book only if (1) “it changes in a meaningful way (apart from federal tax effects) the taxpayer’s economic position” and (2) “the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction.” Under the economic substance provisions of the Green Book, the potential for a profit would also not cause a transaction to have economic substance if the anticipated present value of the pretax profit is not “substantial in relation to the present value of the net federal tax benefits arising from the transaction.” The Green Book would also, if enacted, permit the IRS to issue regulations to further define the scope of the economic substance doctrine.

The Green Book would also impose new penalties intended to discourage taxpayers from engaging in transactions that may lack economic substance. In particular, taxpayers would be assessed a 30% penalty (determined by reference to the amount by which a taxpayer’s tax liability was under-reported) for understating tax liability because of a transaction that was disallowed on economic substance grounds. If a taxpayer made “adequate disclosure of the relevant facts” on the relevant tax return, this penalty would be reduced to 20%. The proposed economic substance penalty could be imposed by the IRS in the absence of a court determination that a transaction lacked economic substance and any abatement by the IRS would have to be “proportionate to the abatement of the underlying tax liability.” This new penalty would be “in lieu of other accuracy-related penalties that might be levied with respect to the tax understatement, although any understatement arising from a lack of economic substance would be taken into account in determining whether there is a substantial understatement of income tax under current law.” Additionally, the Green Book would deny taxpayers deductions for interest attributable to tax understatements arising from the application of the economic substance doctrine.

Under the Green Book, the codified definition of economic substance would apply to transactions entered into after the date of enactment and the denial of the deduction for interest would be effective in taxable years after the date of enactment only for transactions entered into after the date of enactment.

---

<sup>9</sup> See, e.g., *Casebeer v. Comm’r*, 909 F.2d 1360, 1363 (9th Cir. 1990) (observing that “*Frank Lyon* was not intended to outline a rigid two-step analysis,” but rather “the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court’s traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses”).

#### 4. Repeal of Last-In, First-Out (“LIFO”) and Lower-of-Cost-or-Market Inventory (“LCM”) Accounting Methods

Current law permits U.S. taxpayers to elect one of several methods of accounting for inventory, including LIFO accounting.<sup>10</sup> Using the LIFO method to account for inventory for tax purposes can be advantageous because it can permit taxpayers to determine the cost of goods sold using recent inventory, in which taxpayers often have a higher basis. A taxpayer that uses LIFO accounting for U.S. federal income tax purposes is also required to use the LIFO method to account for its inventory on its financial reports.

The Green Book would disallow the use of LIFO inventory accounting in the affected taxpayers’ first taxable year beginning after December 31, 2011. In that year, taxpayers currently using LIFO accounting would be required to revalue their inventory on a first-in, first-out basis and include this one-time increase in gross income ratably over that year and the next ten taxable years. The 2009 Green Book had allowed for ratable inclusion over the year of revaluation and the next seven taxable years.

Under current law, certain taxpayers not using a LIFO method may write down the carrying values of their inventories by applying the lower-of-cost-or-market, or LCM method.<sup>11</sup> Additionally, current law permits taxpayers to write-down the value of subnormal goods that either cannot be sold at normal prices or are otherwise unusable in the normal way because of damage, imperfection or other similar causes.<sup>12</sup> The Green Book asserts that both the LCM method and current provisions permitting taxpayers to write down “subnormal” inventory create distortions that permit taxpayers to understate their taxable income. Accordingly, the Green Book would statutorily prohibit the use of the LCM and subnormal goods methods. Appropriate wash-sale rules would also be included to prevent taxpayers from circumventing the prohibition. Unlike the 2009 Green Book, the current Green Book does not require taxpayers electing to use the retail method (which adjusts inventory costs based on prevailing retail prices) to employ the same method for financial accounting purposes. This aspect of the Green Book proposal would be treated as a change in the method of accounting for inventories, and any resulting adjustment generally would be included in income ratably over a four-year period beginning with the year of change. This would be effective for taxable years beginning after 12 months from the date of enactment.

#### 5. Certain Reorganizations

Current law limits the amount of gain that an exchanging shareholder must recognize in a transaction that would, if not for the receipt of certain property, otherwise qualify for tax-free treatment under Code Section 354 or 355 to the lesser of the “boot” received (i.e., cash or other non-qualified consideration) or

---

<sup>10</sup> See generally Sections 471-475.

<sup>11</sup> See Treas. Reg. § 1.471-4.

<sup>12</sup> See Treas. Reg. § 1.471-2(c).

## SULLIVAN & CROMWELL LLP

the total amount of gain that is realized by the exchange.<sup>13</sup> Additionally, exchanges that have the effect of a dividend distribution can cause all or part of the gain recognized to reduce the corporation's earnings and profits.<sup>14</sup> The Administration believes that these provisions permit U.S. taxpayers to repatriate profits at inappropriately low U.S. tax rates and notes in the Green Book that these provisions currently permit shareholders that own stock in which there is very little (or no) built-in gain to recognize little or no gain in such exchanges, even when most or all of the consideration received is "boot" and the corporation has earnings and profits that equal or exceed the amount of "boot" distributed (for example, if shares with a basis of \$200 were exchanged by a corporation, in a transaction that would otherwise qualify for tax-free treatment under Section 354, for shares worth \$100, and \$100 of cash, the corporation would not recognize any gain, even if the \$100 of cash were supported by the corporation's earnings and profits). Accordingly, the Administration has proposed repealing the "boot within gain limitation" with respect to reorganizations in which the exchange is treated as a dividend under Section 356(a)(2). This provision is similar to a provision in the 2009 Green Book, but unlike the related provision in the 2009 Green Book, is not limited in scope to transactions in which the acquiror is foreign. This aspect of the Green Book proposal would be effective for taxable years beginning after December 31, 2010.

### **6. Accrual of Income on Forward Sale of Corporate Stock**

Currently, a corporation making a forward sale of its own stock does not recognize gain or loss.<sup>15</sup> In contrast, if a corporation currently issues stock in exchange for deferred payments, the corporation accrues interest income on the deferred payments.<sup>16</sup> The Green Book argues that a forward sale of a corporation's own stock and a current sale of such stock for deferred payment are economically equivalent transactions and that both transactions should be taxed similarly. Accordingly, the Green Book 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 payment of interest. If enacted, this new rule would apply to forward contracts entered into after December 31, 2011. The 2009 Green Book would have applied this provision to forward contracts entered into after December 31, 2010.

### **7. Ordinary Treatment for Certain Dealers of Derivatives and Commodities**

Under current law, commodities dealers, commodities derivative dealers, dealers in securities and options dealers treat 60% of their income or loss from certain dealer activities as long-term capital gain or loss

---

<sup>13</sup> See Section 356(a)(1).

<sup>14</sup> See Section 356(a)(2).

<sup>15</sup> See Section 1032(a).

<sup>16</sup> In this case, the corporation is deemed to have issued a loan to the purchasing party in the deferred-payment sale and is taxed on the interest income derived from the deemed loan.

and 40% of their income or loss as short-term capital gain or loss.<sup>17</sup> The Green Book argues that there is no difference between the dealers described above and dealers in other types of property and proposes to require commodities dealers, commodities derivative dealers, dealers in securities and options dealers to treat the income from their dealer activities as ordinary in character. Although the Green Book speaks only of income, it is possible that any loss from such dealer activities would also be treated as ordinary. This aspect of the Green Book would become effective in taxable years beginning after the date of enactment.

#### **8. Expansion of Definition of “Control” for Purposes of the Section 249 Deduction Limit**

Section 249 may disallow or limit the issuer’s deduction for a premium paid to repurchase a debt instrument that is convertible into its own stock, or into stock of a corporation in control of or controlled by the issuer. “Control” is determined for this purpose by reference to Section 368(c), which encompasses only direct relationships and does not include indirectly owned entities such as second-tier subsidiaries.<sup>18</sup> Under the Green Book, the definition of “control” in Section 249(b)(2) would be amended to incorporate generally a parent-subsiary controlled group, in which one or more chains of corporations are connected through stock ownership of a common parent corporation. This aspect of the Green Book would be effective on the date of enactment.

#### **9. Limitation on Dividends-Received Deduction for Life Insurance Company Separate Accounts**

Under current law, a life insurance company is entitled to a dividends-received deduction (“DRD”) only for a portion of dividends received on stocks held in either the life insurance company’s general account or in any separate account established to support variable life insurance and variable annuity contracts, the assets of which are legally segregated from those in the general account.<sup>19</sup> With respect to a separate account, the DRD is allowed only to the extent of the life insurance company’s “share” of the dividends

---

<sup>17</sup> See Sections 1256 & 475(c)(2).

<sup>18</sup> The Green Book provides that Section 249(b)(2) would be amended to incorporate indirect control relationships “of the nature described in Section 1563(a)(1).” Section 1563(a)(1) defines “Parent-subsiary controlled group” as “one or more chains of corporations connected through stock ownership with a common parent corporation” if (1) stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations, and (2) the common parent corporation owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

<sup>19</sup> See *generally* Section 817(c). For purposes of Sections 801-818 (excluding Section 809 before its repeal), a life insurance company issuing variable contracts is required to account separately for the various income, exclusion, deduction, asset, reserve and other liability items properly attributable to various contracts.

## SULLIVAN & CROMWELL LLP

attributable to each separate account, which is the percentage of (1) the company's "share" of net investment income of that separate account for the taxable year, divided by (2) the total net investment income of that separate account for the taxable year.<sup>20</sup>

The life insurance company's "share" of net investment income of a separate account is calculated by a proration method, which requires, among other things, subtracting the "required interest" for the life insurance contracts from the net investment income.<sup>21</sup> The "required interest" with regard to a separate account is currently calculated by multiplying a specified account earnings rate ("ER") by the mean of the reserves with regard to the account for the taxable year.<sup>22</sup> The Green Book expresses concern that this formula will, in many cases, overstate the company's actual economic interest in a separate account's investment income.

Accordingly, the Green Book would set the ER of each separate account of a life insurance company to be equal to a gross earnings rate (net investment income of the account divided by the mean of the account's assets), minus a company-retained percentage (amounts retained by the company from the account's net investment income, if any, divided by the mean of reserves). The Green Book states that this formula is intended to produce a company's "share" of dividends attributable to a separate account that bears a more direct relationship to the company's actual economic interest in the separate account. This aspect of the Green Book would be effective for taxable years beginning after December 31, 2010.

### **10. Expansion of Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance ("COLI")**

Under current law, to the extent that indebtedness can be traced to a life insurance, endowment or annuity contract, interest on such indebtedness generally is not deductible, unless the insurance contract

---

<sup>20</sup> See Section 812(a)(1).

<sup>21</sup> See Section 812(b), which provides that the company's share of net investment income equals the excess (if any) of net investment income for the taxable year over the sum of (1) policy interest, and (2) gross investment income's proportionate share of policyholder dividends for the taxable year. Section 812(b) further provides that policy interest consists of the sum of the following items: (1) "required interest" for reserve items described in Section 807(c), (2) the deductible portion of excess interest, (3) the deductible portion (not otherwise taken into account as required interest or excess interest) of amounts credited to a policyholder's fund under a pension plan contract for employees not yet retired or under a deferred annuity contract prior to the annuity starting date and (4) interest on amounts left on deposit with the company. Section 812(b) provides that net investment income is 95% of gross investment income attributable to assets held in a separate account under variable life insurance contracts.

<sup>22</sup> Under current law, ER is the interest rate used in determining the contract's reserve. See Section 807(d). Such interest rate can be either (1) the greater of the applicable federal interest rate or the prevailing state assumed interest rate for the contract, or (2) another appropriate rate. See Section 812(b); Rev. Rul. 2003-120, 2003-2 C.B. 1154. In some situations, "another appropriate rate" for a taxpayer's variable separate accounts is determined in accordance with the formula under Treas. Reg. § 1.801-8(e)(1) with some modifications. See IRS Letter Ruling 200339049 (August 20, 2002).

## SULLIVAN & CROMWELL LLP

insures the life of a key person of the business.<sup>23</sup> In addition, the interest deductions of a business other than an insurance company are reduced to the extent such interest is allocable (but not directly traceable) to unborrowed policy cash values (based on a statutory formula) of life insurance, endowment or annuity contracts, unless such contracts cover individuals who are officers, directors, employees or 20% owners of the taxpayer.<sup>24</sup> Similar rules apply to life and non-life insurance companies.

The Green Book argues that both exceptions to the interest deduction disallowance rule described in the paragraph above provide leveraged businesses with tax-exempt or tax-deferred income funded by deductible interest expenses. The Green Book, if enacted, would repeal these exceptions for contracts issued after December 31, 2010. For this purpose, any material increase in the death benefit or other material change in the contract would be treated as a new contract except that in the case of a master contract, the addition of covered lives would be treated as a new contract only with respect to the additional covered lives. The 2009 Green Book would have repealed these exceptions for contracts entered into after the date of enactment and did not discuss the consequences of changes in the contract.

### **11. Repeal of Certain Oil and Gas Company Preferences**

The Green Book would repeal certain tax preferences for oil and gas companies that exist under current law. In particular, the Green Book would (1) repeal the investment tax credit for enhanced oil recovery projects, (2) repeal the production tax credit for oil and gas from marginal wells, (3) require that intangible drilling costs paid or incurred be capitalized (instead of being deducted) as depreciable or depletable property in accordance with generally applicable rules, (4) discontinue the deduction for qualified tertiary injectant expenses, (5) repeal the exception from the passive activity loss rules for working interests in oil and gas properties with respect to which the owner has not limited its liability, (6) disallow percentage depletion with respect to oil and gas wells, and instead require cost depletion, (7) end the domestic manufacturing deduction for oil and gas production and (8) increase the amortization period for geological and geophysical expenditures incurred by independent producers in connection with all oil and gas exploration in the United States from two years to seven years. Unlike the 2009 Green Book, the current Green Book would not impose an excise tax on certain oil and gas produced on the outer continental shelf. These provisions would be generally effective for taxable years beginning after December 31, 2010.

### **12. Disallowance of Deduction for Punitive Damages**

Under current law, a deduction is allowed for damages paid or incurred as ordinary and necessary expenses in carrying on any trade or business, regardless of whether such damages are compensatory

---

<sup>23</sup> See Section 264.

<sup>24</sup> See *id.*

## SULLIVAN & CROMWELL LLP

or punitive. In contrast, fines, similar penalties and amounts paid to governments and governmental agencies in respect of certain judgments are not deductible.<sup>25</sup>

The Green Book would disallow deductions for punitive damages and would require that any insurance payments on account of such punitive damages be included in the gross income of the insured person. Whereas the 2009 Green Book would have applied to damages paid or incurred after December 31, 2010, the current Green Book would apply to damages paid or incurred after December 31, 2011. The Green Book is not clear whether this disallowance would also apply to any damages paid after December 31, 2011, if attributable to events occurring before this date.

### 13. Extension of Temporary Bonus Depreciation for Certain Property

Current law provides for an additional first-year depreciation deduction for “qualified property” equal to 50% of the cost of qualified property.<sup>26</sup> For this purpose, “qualified property” generally includes tangible property with a recovery period of 20 years or less that the taxpayer purchased (or began the manufacture or construction of) in 2008 or 2009 and that the taxpayer placed into service before January 1, 2010. Corporations otherwise eligible for additional first-year depreciation may elect to claim additional research or minimum tax credits in lieu of claiming the additional depreciation for “eligible qualified property.”<sup>27</sup> Such property only includes otherwise qualified property that was acquired after March 31, 2008, and only basis attributable to the property’s manufacture or construction after that date is taken into account. If a corporation elects to claim additional research or minimum tax credits, then depreciation with respect to eligible qualified property must be computed using the straight-line method.

The Green Book would extend the additional first-year depreciation deduction for one year, generally for property acquired and placed into service during 2010. The election for claiming additional research or minimum tax credits in lieu of the additional depreciation deduction would also be extended by one year. The Green Book explains that by accelerating in time the recovery of investment costs, the additional first-year deduction for new investment lowers the after-tax costs of capital purchases which, in turn, encourages new investment and promotes economic recovery. This aspect of the Green Book would be effective for qualified property placed into service after December 31, 2009, and was not included in the 2009 Green Book.

---

<sup>25</sup> See Sections 162(f) &(g).

<sup>26</sup> See Section 168(k)(1).

<sup>27</sup> See Section 168(k)(4).

### 14. Removal of Cell Phones from Listed Property

Generally, a taxpayer may claim a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.<sup>28</sup> However, the deduction is limited with respect to “listed property,” which includes any cellular telephone or other similar telecommunications equipment (as well as certain other property specified by statute). In particular, a deduction with respect to expenses for listed property is disallowed unless the taxpayer substantiates (1) the amount of such expense, (2) the use of the listed property, (3) the business purpose of the expense and (4) the business relationship to the taxpayer of persons using the listed property. In addition, annual depreciation deductions are limited with respect to listed property not used predominantly for business purposes. However, under the Green Book proposal, cell phones and other telecommunications equipment (e.g., blackberries and so-called smart phones) would no longer be classified as listed property. This change would effectively remove the substantiation-of-use requirement and the limitation on depreciation deductions. This aspect of the Green Book would be effective for taxable years ending after the date of enactment and was not included in the 2009 Green Book.

Moreover, under current law, an employee generally must include in gross income the fair market value of a fringe benefit (reduced by any amount paid by the employee or specifically excluded from income). To the extent an employee uses a business cell phone for personal purposes, the fair market value of such usage is includable in the employee’s gross income. However, the Green Book would exclude from gross income the fair market value of personal use of a cell phone (or other similar telecommunications equipment) provided primarily for business purposes. This aspect of the Green Book would be effective for taxable years ending after the date of enactment and was not included in the 2009 Green Book.

### 15. Extension of Statute of Limitations

Unless a statutory or another exception applies, additional federal tax liabilities in the form of tax, interest, penalties and additions to tax must be assessed by the IRS within three years after the date a return is filed.<sup>29</sup> The Green Book would create an additional exception to the three-year statute of limitations for assessment of federal tax liabilities attributable to an adjustment to state or local tax liabilities. The statute of limitations would be extended by the greater of: (1) one year from the date the taxpayer first files an amended tax return with the IRS reflecting adjustments to the state or local tax return, or (2) two years from the date the IRS first receives information from the state or local revenue agency under an information-sharing agreement in place between the IRS and a state or local revenue agency. The statute of limitations would only be extended with respect to the increase in federal tax attributable to the state or local tax adjustment. The statute of limitations would not be further extended if the taxpayer files

---

<sup>28</sup> See Section 162.

<sup>29</sup> See Section 6501.

## SULLIVAN & CROMWELL LLP

additional amended returns for the same tax periods as the initial amended return or if the IRS receives additional information from the state or local revenue agency under an information-sharing agreement. The statute of limitations on refund claims would also be extended correspondingly. This aspect of the Green Book would be effective for returns required to be filed after December 31, 2010. By contrast, the 2009 Green Book would have been effective for returns required to be filed after December 31, 2009.

### **16. Reporting of Certain Payments to Service Providers by Recipients of Rental Payments**

The Green Book would require that recipients of real estate rental income that make payments of \$600 or more to a service provider in the course of earning rental income send an information return (generally Form 1099-MISC) to the IRS and the service provider. Certain exceptions would be made for “particularly burdensome situations.” If enacted, this provision would be effective for tax years beginning after December 31, 2010. By contrast, the 2009 Green Book would have been effective for tax years beginning after December 31, 2009.

### **17. Information Reporting for Private Separate Accounts of Life Insurance Companies**

Investments in a variable annuity or life insurance contract held in a separate account through a life insurance company can give rise to either tax-deferred income or life insurance benefits that are paid tax-free to the policyholder.<sup>30</sup> This favorable treatment is not available, however, if the policyholder has so much control over the investments in the separate account that the policyholder, rather than the insurance company, is treated as the owner of those investments (which is often referred to as the “investor control doctrine”).<sup>31</sup>

The Green Book would require life insurance companies to report certain information to the IRS with respect to any life insurance or annuity contract the cash value of which is partially or wholly invested in a private separate account for any portion of the taxable year. This provision is intended to enable the IRS to identify which variable life insurance contracts should be disregarded under the investor control doctrine. The Green Book, if enacted, would require such reporting for any account with respect to which a related group of persons owns policies the cash values of which, in the aggregate, represent at least 10% of the value of the separate account. Unlike the 2009 Green Book, the current Green Book provides that whether a related group of persons owns policies whose cash values represent at least 10% of the value of the account would be determined quarterly, based on information reasonably within the issuer’s possession. This aspect of the Green Book would be effective for taxable years beginning after December 31, 2010.

---

<sup>30</sup> See *generally* Section 817.

<sup>31</sup> See Rev. Rul. 81-225, 1981-2 C.B. 12, in which the IRS set forth a series of factual circumstances for purposes of determining whether mutual fund shares underlying an annuity contract would be considered as owned by the contract holder or the issuing life insurance company for federal income tax purposes. See *also* Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 2003-92, 2003-2 C.B. 350.

**18. Information Reporting on Payments to Corporations and Electronic Filing by Certain Large Organizations**

Under current law, payments to corporations are generally exempt from information reporting.<sup>32</sup> Under the Green Book, businesses would be required to file information returns for payments for services or determinable gains aggregating to \$600 or more in a calendar year to any corporation (except a tax-exempt corporation). Unlike the 2009 Green Book, the current Green Book would provide regulatory authority to make appropriate exceptions where reporting would be especially burdensome. Whereas this aspect of the 2009 Green Book would have been effective for payments made after December 31, 2009, this aspect of the current Green Book would be effective for payments made after December 31, 2010. Additionally, under the Green Book, all corporations and partnerships that are currently required to file a Schedule M-3<sup>33</sup> and certain other large taxpayers would be required to file their tax returns electronically for tax years ending after December 31, 2010. This aspect of the 2009 Green Book would have applied for tax years ending after December 31, 2009.

**B. TAX REDUCTIONS FOR BUSINESS**

**1. Elimination of Capital Gains Taxation on Investments in Small Business Stock**

The Green Book would increase the percentage exclusion of gains from the sale by a taxpayer other than a corporation of certain small business stock acquired at original issue and held for at least five years from 50% to 100% and eliminate the alternative minimum tax preference item for gains excluded under this provision. For this purpose, a “small business” generally means any domestic C corporation if, when the stock is issued, such corporation does not have gross assets exceeding \$50 million (including the proceeds of the newly issued stock) and is not an S corporation. This proposal would be effective for qualified small business stock issued after February 17, 2009.

**2. The Research and Experimentation Tax Credit Made Permanent**

The Green Book would make permanent the Research & Experimentation tax credit, which is currently scheduled to expire on December 31, 2009.

**3. Continuation of Certain Expiring Provisions Through Calendar Year 2011**

The Green Book would extend certain expiring provisions through December 31, 2011, including, among others, the optional deduction for state and local general sales taxes, subpart F “active financing” and

---

<sup>32</sup> See generally Treas. Reg. § 1.6049-4(c).

<sup>33</sup> Schedule M-3 “Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More” is a schedule to IRS Form 1120 “U.S. Corporation Income Tax Return.” Any corporation or U.S. consolidated group that is required to file Form 1120 and that reports on Schedule L of Form 1120 “Balance Sheets per Books” with total assets at the end of the corporation’s or group’s taxable year of at least \$10 million must file Schedule M-3.

## SULLIVAN & CROMWELL LLP

“look-through” exceptions, and the exclusion from unrelated business income of certain payments to controlling exempt organizations.<sup>34</sup> The 2009 Green Book would have extended these provisions through December 31, 2010.

\* \* \*

Copyright © Sullivan & Cromwell LLP 2010

---

<sup>34</sup> The Extenders Bill contained these same extensions.

# SULLIVAN & CROMWELL LLP

## ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance and corporate transactions, significant litigation and corporate investigations, and complex regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 700 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

## CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jennifer Rish (+1-212-558-3715; [rishj@sullcrom.com](mailto:rishj@sullcrom.com)) or Alison Alifano (+1-212-558-4896; [alifanoa@sullcrom.com](mailto:alifanoa@sullcrom.com)) in our New York office.

## CONTACTS

---

### New York

David P. Hariton	+1-212-558-4248	<a href="mailto:haritond@sullcrom.com">haritond@sullcrom.com</a>
Andrew S. Mason	+1-212-558-3759	<a href="mailto:masona@sullcrom.com">masona@sullcrom.com</a>
David C. Spitzer	+1-212-558-4376	<a href="mailto:spitzerd@sullcrom.com">spitzerd@sullcrom.com</a>
Diana L. Wollman	+1-212-558-4055	<a href="mailto:wollmand@sullcrom.com">wollmand@sullcrom.com</a>
James R. Gadwood	+1-212-558-7346	<a href="mailto:gadwoodj@sullcrom.com">gadwoodj@sullcrom.com</a>
Michael Orchowski	+1-212-558-7916	<a href="mailto:orchowskim@sullcrom.com">orchowskim@sullcrom.com</a>

---

### Washington, D.C.

Donald L. Korb	+1-202-956-7675	<a href="mailto:korbd@sullcrom.com">korbd@sullcrom.com</a>
----------------	-----------------	--

---

### London

S. Eric Wang	+44-20-7959-8411	<a href="mailto:wangs@sullcrom.com">wangs@sullcrom.com</a>
Andrew P. Solomon	+44-20-7959-8535	<a href="mailto:solomona@sullcrom.com">solomona@sullcrom.com</a>

---