President Obama's Fiscal Year 2014 Revenue Proposals

Proposals Relating to Domestic Business Taxation

SUMMARY
On April 10, 2013, the Obama Administration (the “Administration”) released the General Explanations of the Administration’s Fiscal Year 2014 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 2014 budget proposals. This memorandum discusses key aspects of the Green Book relating to domestic business taxation. We are distributing separate memoranda addressing Green Book proposals affecting (1) individuals, retirement plans, and estate and gift taxation and (2) international taxation, both of which may be obtained by following the instructions at the end of this memorandum.

The Green Book’s domestic business proposals would make significant changes to existing law, including the first five proposals discussed below which were not contained in the General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals (the “2013 Green Book”). The proposals related to domestic business taxation include:

- marking to market derivative contracts;
- imposing liability on shareholders participating in “Intermediary Transaction Tax Shelters”;
- eliminating the Employee Stock Ownership Plan dividend deduction for large C corporations;
- repealing the technical termination rule for partnerships;
- repealing the anti-churning rules for certain intangibles;
- promoting “insourcing” and reducing “outsourcing” of U.S. jobs by creating a new tax credit, and eliminating certain deductions, related to the relocation of a business;
- imposing a Financial Crisis Responsibility Fee on large financial firms;
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- taxing carried interests in “investment service partnerships” as ordinary income and as net earnings from self-employment;
- limiting the shifting of losses from the transferor to the transferee under the related party loss limitation rules;
- expanding the definition of “built-in loss” for purposes of partnership loss transfers;
- repealing the last-in, first-out and the lower-of-cost-or-market inventory accounting methods;
- repealing the “boot-within-gain” rule and the non-qualified preferred stock designation for certain reorganizations;
- disallowing deductions for punitive damages;
- limiting the dividends-received deduction for life insurance company separate accounts;
- expanding the disallowance of interest deductions for corporate-owned life insurance contracts;
- repealing the estimated tax payment for certain insurance companies;
- repealing the rule denying a dividends-paid deduction for “preferential dividends” paid by publicly traded and publicly offered real estate investment trusts;
- repealing certain oil and gas company preferences;
- modifying rules that apply to the sale of life insurance contracts;
- requiring information reporting for private separate accounts of life insurance companies;
- extending the statute of limitations for federal tax liabilities in connection with certain state or local tax liability adjustments;
- extending temporary bonus depreciation for certain property;
- extending partnership basis limitation rules to nondeductible expenditures;
- eliminating capital gains taxation on investments by non-corporate taxpayers in small business stock; and
- enhancing and making the research and experimentation tax credit permanent.

The Green Book also contains a proposal not contained in the 2013 Green Book that would exempt foreign pension funds that satisfy certain requirements from the application of the Foreign Investment in Real Property Tax Act. For more information regarding that proposal, please see the separate memorandum addressing Green Book proposals relating to international taxation, which may be obtained by following the instructions at the end of this memorandum.

DISCUSSION

A. REVENUE PROVISIONS

1. Marked to Market of Derivative Contracts

The Green Book proposal would require that gain or loss from a “derivative contract” be “marked to market” on an annual basis (the contract would be treated as if it were sold for its fair market value no later than the last business day of the taxpayer’s taxable year). Any gain or loss would be treated as ordinary and as attributable to a trade or business of the taxpayer (i.e., loss could offset income from...
unrelated activities), while the source of income associated with a derivative would continue to be
determined under current law. For these purposes, a “derivative contract” would be broadly defined to
include (i) any contract the value of which is determined, directly or indirectly, in whole or in part, by the
value of actively traded property, and (ii) any contract with respect to a contract that is described in clause
(i). This mark to market regime would also apply to a financial instrument, e.g. stock, not otherwise
subject to mark to market if it formed a straddle with a derivative contract (e.g. if a derivative contract,
such as a put or call option, served to diminish the taxpayer’s risk of loss). Additionally, any derivative
contract that is embedded in another contract would be subject to mark to market if the derivative by itself
would be marked to market.

The Green Book proposal would provide an exception to this mark to market ordinary treatment for a
“business hedging transaction,” which is a transaction that is entered into in the ordinary course of a
taxpayer’s trade or business primarily to manage risk of price changes (including changes related to
interest rates, currency fluctuations, or creditworthiness) with respect to ordinary property or ordinary
obligations, and that is identified as a hedging transaction before the close of the day on which it was
acquired, originated, or entered into. A transaction would satisfy the identification requirement if it was
identified as a business hedge for financial accounting purposes and it hedged price changes on ordinary
property or obligations.

The Green Book proposal is similar to a proposal that the U.S. House Ways and Means Committee is
studying at the behest of Chairman Camp (the “Camp Proposal”), which was released on January 24,
2013. Like the Green Book proposal, the Camp Proposal would require “derivatives”\(^1\) to be accounted for
on a mark to market basis, with the resulting gains or losses treated as ordinary and attributable to a
trade or business of the taxpayer, and would contain an exception to mark to market accounting for
qualifying hedging transactions. Unlike the Camp Proposal, however, the Green Book proposal would
only be applied to derivatives that reference actively traded positions, but also unlike the Camp Proposal,
it could apply to contingent debt instruments. Nevertheless, the Green Book proposal could apply to a
broad range of financial instruments, including structured notes, indexed notes, convertible,
exchangeable or contingent debt instruments, put and call options, short sales, stock loans and even
incentive-related compensation.

The Green Book proposal would apply to derivative contracts entered into after December 31, 2013. The
Green Book proposal states that it would eliminate Code Sections 1256 (mark to market and 60/40 capital

\(^1\) The Camp Proposal would define a “derivative” as: (1) any evidence of an interest in, or any
derivative instrument with respect to, any (a) share of stock in a corporation, (b) partnership interest
or beneficial ownership interest in a partnership interest or trust, (c) note, bond, debenture, or other
evidence of indebtedness, (d) certain real property, (e) actively traded commodity, or (f) currency; (2)
any notional principal contract; and (3) any derivative instrument with respect to any interest or
instrument described above.
gain) and 1092 (tax straddles), and “significantly curtail” Code Sections 1233 (short sales), 1234 (gain or loss from an option), 1234A (gains or losses from certain terminations), 1258 (conversion transactions), 1259 (constructive sales transactions), and 1260 (constructive ownership transactions).

2. Impose Liability on Shareholders Participating in “Intermediary Transaction Tax Shelters”

“Intermediary Transaction Tax Shelters” are transactions that have been identified by the Internal Revenue Service as “listed transactions,” which are required to be disclosed on a tax return to avoid certain penalties.2 Intermediary Transaction Tax Shelters have been described by the Internal Revenue Service as generally involving: (1) built-in gain in a C corporation’s assets, (2) the sale of a controlling interest in the stock of the C corporation other than in liquidation of such corporation, (3) the sale of the assets of the C corporation either shortly before or shortly after the sale of the C corporation’s stock, and (4) at least half of the C corporation’s tax liability for the sold built-in gain assets purportedly offset or avoided or not paid.3 The Green Book provides the following “typical” example of an Intermediary Transaction Tax Shelter: An intermediary entity borrows funds to purchase the stock of the C corporation from the C corporation’s shareholders (the sales price is inflated to reflect that the C corporation’s income tax liability with respect to the sale of its assets will not be paid, as described below). The consideration received by the C corporation from the sale of its assets is effectively used to repay loans incurred to finance the purchase of the C corporation’s stock. No assets are left inside the C corporation to pay the C corporation’s income tax liability.

The Green Book asserts that taxpayers have continued to engage in Intermediary Transaction Tax Shelters despite their designation as listed transactions because of the federal government’s “inability to effectively collect” amounts owed by the asset-poor C corporation.4 Accordingly, the Green Book states that existing law does not “adequately protect” the federal government’s interest in collecting the amounts due as a result of these transactions.

The Green Book proposal would add a new Code section that would impose liability on certain shareholders who sell their C corporation stock as part of a plan constituting an Intermediary Transaction Tax Shelter (to be defined in regulations issued by the Treasury). Under current law outside of the consolidated return context, there are limited circumstances in which former shareholders of a C corporation are liable for unpaid income taxes, interest, additions to tax, or penalties owed by the C corporation, and the Internal Revenue Service has generally been unable to establish that these circumstances have existed in cases in which the Internal Revenue Service has asserted that the former shareholders of a C corporation should be liable for the C corporation’s tax in an Intermediary Transaction

4 See infra footnote 5.
Tax Shelter under a “transferee liability” theory. However, under the Green Book proposal, liability for shareholders would arise if the shareholders, as part of a plan (or series of related transactions) constituting an Intermediary Transaction Tax Shelter, directly or indirectly disposed of at least 50 percent of the stock of a C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the C corporation stock. Such liability would arise only after the C corporation was assessed income taxes, interest, additions to tax, and penalties with respect to any taxable year within the 12-month period before or after the date that its stock was disposed of and the C corporation did not pay such amounts within 180 days after assessment.

The amount of a shareholder’s liability would equal the lesser of: (i) the value of the total proceeds received by the shareholder for the disposed stock or (ii) the income tax liability the C corporation would have had if it had liquidated in a fully taxable transaction on the date that at least 50 percent of its stock was sold, decreased by the income tax paid by the C corporation with respect to tax years beginning or ending within 12 months of the date that at least 50 percent of its stock was sold, and increased by any unpaid penalties, additions to tax, and interest owed by the C corporation in such years. The Green Book proposal would also provide that the amount that the selling shareholder was liable for under this new Code section would constitute a deficiency that was governed by the general notice and demand rules of the Code but with an additional year added to the statute of limitations for assessment.

The Green Book proposal would, however, contain an exception for dispositions of a controlling interest in certain publicly owned entities.

The Green Book proposal would be effective upon enactment.

See, e.g., Starnes v. Comm’r, 101 T.C.M. 1283 (2011), aff’d 680 F.3d 417 (4th Cir. 2012) (former shareholders of a corporation were not liable as transferees for income tax deficiencies arising from a subsequent sale of the corporation’s assets; Internal Revenue Service alleged that the transaction was substantially similar to an Intermediary Transaction Tax Shelter); Griffin v. Comm’r, 101 T.C.M. 1274 (2011) (shareholder who sold a corporation’s assets and then all of his corporate stock not liable as a transferee for the corporation’s unpaid income tax liability; Internal Revenue Service argued that the two sales were part of a plan to engage in an Intermediary Transaction Tax Shelter). But see Frank Sawyer Trust v. Comm’r, 2013 WL 1277128 (1st Cir. 2013) (reversing and remanding the Tax Court’s determination that a former shareholder of four corporations could not be held liable as a transferee for such corporations’ taxes and penalties when the corporations’ new shareholders engaged in an “asset-stripping” scheme to leave the corporations insolvent).

The proposal would not apply with respect to dispositions of a controlling interest (1) in the stock of a corporation or real estate investment trust with shares traded on an established securities market in the United States, (2) in the shares of a regulated investment company that offers shares to the public, or (3) to an acquirer whose stock or securities are publicly traded on an established market in the United States, or is consolidated for financial reporting purposes with such a public issuer of stock or securities.
3. Eliminate Employee Stock Ownership Plan Dividend Deduction for Large C Corporations

Under current law, C corporations are generally not entitled to a deduction for dividends paid. However, there is an exception for dividends paid with respect to an employer stock held in an Employee Stock Ownership Plan (“ESOP”) if certain conditions are met. The Green Book asserts that the ESOP dividend deduction incentivizes employees to invest in employer stock, which may have a “productivity incentive effect” most likely to occur in smaller corporations where “each employee’s efforts could more directly affect overall company performance.” However, the Administration believes the concentration of employees’ retirement savings in the stock of the company they work for as increasing the risk to the employees’ retirement benefits (implying that the safety of retirement benefits may correlate with the safety of employees’ jobs) without necessarily a commensurate return.

The Green Book asserts that these competing considerations can be balanced by repealing the deduction for dividends paid with respect to stock held by an ESOP that is sponsored by a C corporation with annual receipts in excess of $5 million.

This proposal would apply to dividends and distributions that are paid after the date of enactment. The Green Book does not address whether pre-existing arrangements will be grandfathered.

4. Repeal Technical Termination of Partnerships

Current law under Code Section 708(b)(1)(B) treats a partnership as terminating for U.S. federal income tax purposes if there is a sale or exchange of 50 percent or more of the total interest in the partnership capital and profits, which is commonly referred to as a “technical termination.” The Green Book notes that a technical termination results in potentially significant U.S. federal income tax consequences, including the restarting of depreciation lives, the close of the partnership’s taxable year, and the loss of partnership level elections. Accordingly, the Green Book asserts that a technical termination serves as either a “trap for the unwary” or an “affirmative planning tool for the savvy taxpayer.”

The Green Book proposal would repeal Code Section 708(b)(1)(B). This proposal would go into effect with respect to transfers on or after December 31, 2013.

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7 See Code Section 404(k).
8 See Treas. Reg. §1.168(k)-1(b)(5)(iii).
9 See Treas. Reg. §1.708-1(b)(3).
10 See Treas. Reg. §1.708-1(b)(5).
5. Repeal the Anti-Churning Rules of Code Section 197

In 1993, Congress enacted Code Section 197 to allow the amortization of certain intangibles such as goodwill and going concern value. Prior to the enactment of Code Section 197, such intangibles were not amortizable. Congress therefore enacted Code Section 197(f)(9), commonly known as the “anti-churning rules,” to prohibit taxpayers from using related party transactions to convert certain intangibles existing prior to the enactment of Code Section 197, and not amortizable under prior law, into amortizable property.

The Green Book proposal would repeal Code Section 197(f)(9). The Green Book asserts that most of the intangibles that exist today are not subject to the anti-churning rules because it has been almost 20 years since the enactment of Code Section 197; yet, taxpayers must diligence whether such intangibles exist and then navigate the complex anti-churning rules to determine how such intangibles are treated. Accordingly, the Green Book states that the complexity and administrative burden associated with the anti-churning rules outweighs the current need for such rules.

This proposal would go into effect with respect to acquisitions after December 31, 2013.

6. Expenses Associated With Insourcing and Outsourcing a U.S. Trade or Business

The Administration believes that there are limited tax incentives for U.S. employers to bring offshore jobs and investments into the United States and the Green Book asserts that creating tax incentives to do so would make the United States more competitive in attracting businesses. Conversely, the Green Book states that under current law, costs incurred to outsource U.S. jobs generally are deductible for U.S. federal income tax purposes.\(^\text{11}\)

Accordingly, the Green Book proposal would create a new general business credit\(^\text{12}\) against income tax equal to 20 percent of the eligible expenses paid or incurred in connection with “insourcing” a U.S. trade or business and would disallow deductions for expenses paid or incurred in connection with “outsourcing” a U.S. trade or business. For purposes of the proposal, (i) “insourcing” (“outsourcing”) a U.S. trade or business means reducing or eliminating a trade or business or line of business currently conducted outside (inside) the United States and starting up, expanding, or otherwise moving the same trade or business inside (outside) the United States, to the extent that this action results in a gain (loss) of U.S. jobs, and (ii) “expenses paid or incurred in connection with” insourcing or outsourcing a U.S. trade or business would be limited solely to expenses associated with the relocation of the trade or business and would not include capital expenditures or costs for severance pay and other assistance to displaced employees.

\(^{11}\) See Code Section 162.

\(^{12}\) Under the Green Book proposal, the creditable costs may be incurred by the foreign subsidiary of the U.S. company and the tax credit would be claimed by the U.S. parent company.
workers. Additionally, in determining the “subpart F income” of a controlled foreign corporation, the Green Book proposal would allow no reduction for any expenses associated with moving a U.S. trade or business outside the United States.

The Green Book proposal would be effective for expenses paid or incurred after the date of enactment.

7. Imposition of a Financial Crisis Responsibility Fee

The Green Book would impose a Financial Crisis Responsibility Fee at a rate of 17 basis points on certain liabilities of the largest firms in the financial sector. A 50 percent discount would apply to more stable sources of funding (such as long-term liabilities). The Green Book explains that the fee is designed to “discourage excessive risk-taking” and to satisfy the statutory requirement of the Troubled Asset Relief Program (“TARP”), which requires the President to propose an assessment on the financial sector to pay back the costs of TARP. The Green Book adds that the structure of this fee would be “broadly consistent” with the principles agreed to by the G-20 leaders and similar to fees that have been adopted or proposed by other countries.

The fee would be imposed on U.S. based bank and thrift holding companies, certain broker-dealers, companies that control certain broker-dealers, and insured depository institutions as well as U.S. companies owning or controlling these types of entities as of January 14, 2010. Firms with worldwide consolidated assets of less than $50 billion would not be subject to the fee for periods 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.

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 businesses. In computing covered liabilities, insurance companies would be able to deduct certain insurance policy reserves and other policyholder obligations. Covered liabilities would be determined using the balance sheet information filed with the appropriate federal or state regulators, subject to adjustments to be made in order to prevent avoidance of these rules. The fee would be deductible in computing corporate income tax.

The Green Book proposal would be effective as of January 1, 2015.

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13 U.S. shareholders of a controlled foreign corporation are taxed currently on some types of the controlled foreign corporation's undistributed income (generally, passive income and some intercompany sales and services income) known as "subpart F income", as if these shareholders had received a dividend of this subpart F income.
8. Taxation of Carried Interests in “Investment Services Partnerships” 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” in the partnerships, and the character of income from the partnership flows through to the holders of the carried interests. 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.

The Green Book proposal would characterize income derived from an “investment services partnership interest” ("ISPI") as ordinary income, regardless of the character of the income at the partnership level, and would generally characterize gain derived from the sale of an ISPI as ordinary income (where the “investment partnership” has goodwill or other assets unrelated to the services of the ISPI holder, the Green Book proposal notes that the Administration would work with Congress to develop mechanisms that characterize gain on the sale of an ISPI consistently with the sales of other types of businesses). An ISPI is a carried interest in an investment partnership held by a person who provides services to the partnership. An “investment partnership” is defined as a partnership if substantially all of its assets are investment-type assets (i.e., certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership’s contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business.

The Green Book proposal would include an exemption from ISPI status to the extent a partner’s interest in the partnership is a “qualified capital interest” attributable to a partner’s contribution of “invested capital,” which would not include loans or advances guaranteed by any partner or the partnership. This exemption would generally require that (i) partnership allocations to the invested capital be in a same

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14 A profits interest is an interest in a partnership that is not a capital interest; accordingly, profits interests have no liquidation value upon issuance. See Rev. Proc. 93-27, 1993-2 C.B. 343.

15 See Code Section 702(b).

16 See Code Section 751.
manner as allocations to other capital interests held by partners who do not hold an ISPI and (ii) the allocations to these non-ISPI holders are significant allocations. The Green Book proposal would also generally treat any income or gain from an ISPI as net earnings from self-employment for FICA purposes and thus subject to Social Security and Medicare tax. The Green Book proposal 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 proposal would include an anti-abuse rule, pursuant to which 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 or 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, 2013. The Green Book does not address whether pre-existing arrangements will be grandfathered.

9. Limit the Shifting of Losses under the Related Party Loss Limitation Rules

Under current law, no deduction is allowed from the sale or exchange of property, directly or indirectly, between related persons. In such a case, Code Section 267(d) provides that the transferee of such property is permitted to reduce any subsequent gain on a sale or disposition of such property to an unrelated party to the extent of the transferor’s disallowed loss. The Green Book asserts that in certain situations taxpayers might use this Code section to shift the benefit of a loss from a transferor, in whose hands gain or loss with respect to the property is not subject to U.S. federal income tax, to a transferee able to utilize the loss.

The Green Book proposal would amend section 267(d) to provide that a transferee’s subsequent gain with respect to the transferred property is not reduced by a transferor’s prior disallowed loss to the extent that (i) gain or loss with respect to the property is not subject to U.S. federal income tax in the hands of the transferor immediately before the transfer, but (ii) gain or loss with respect to the property is subject to U.S. federal income tax in the hands of the transferee immediately after the transfer.

The proposal would apply to transfers made after the date of enactment.

10. Expand the Definition of Built-in Loss for Purposes of Partnership Loss Transfers

Following the transfer of a partnership interest, a partnership must adjust the basis of partnership property with respect to the transferee partner if the partnership either has made an election under Code Section

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17 See Code Section 267(a)(1) and Code Section 707(b)(1)
754 or has a “substantial built-in loss” in its assets.\(^{18}\) A partnership’s built-in loss in its assets is “substantial” under current law if the partnership’s adjusted basis in its assets exceeds the fair market value of such property by more than $250,000.

The Green Book proposal would expand the definition of a “substantial built-in loss” to include situations (to the extent not already included under current law) where the transferee partner would be allocated a net loss in excess of $250,000 assuming a hypothetical disposition by the partnership of all of the partnership’s assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of its assets.

The Green Book proposal would apply to sales or exchanges after the date of enactment.

11. 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 last-in, first-out (“LIFO”) accounting.\(^{19}\) The LIFO method can be advantageous in reducing the amount of income recognized by taxpayers on a sale of inventory, because under this method taxpayers determine the cost of goods sold by 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 proposal would eliminate the LIFO method of accounting for U.S. federal income tax purposes. Taxpayers using the LIFO method of accounting would be required to change their method of inventory accounting, resulting in the inclusion of income deferred under the LIFO method. The adjustment resulting from this accounting method change would be a one-time increase in gross income taken into account ratably over a ten-year period beginning with the year of change. This repeal would be effective for the first taxable years beginning after December 31, 2013.

Under current law, certain taxpayers not using the LIFO method may write down the carrying values of their inventories by applying the lower-of-cost-or-market (“LCM”) method.\(^{20}\) 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.\(^{21}\)

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.

\(^{18}\) See Code Section 743(b).

\(^{19}\) See generally Code Sections 471-475.


\(^{21}\) See Treas. Reg. § 1.471-2(c).
Accordingly, the Green Book proposal would statutorily prohibit the use of the LCM and subnormal goods methods. Wash-sale rules would also be included to prevent taxpayers from circumventing the prohibition. The Green Book proposal would be treated as a change in the method of inventory 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. The Green Book proposal would be effective for taxable years beginning after December 31, 2013.

12. Certain Reorganizations

a. Boot-within-Gain Limitation Rule

Current law limits the amount of gain that an exchanging shareholder recognizes in a “reorganization” transaction that would, if not for the receipt of certain property, otherwise qualify for tax-free treatment to the lesser of the “boot” received (i.e., cash or other non-qualified consideration) or the total amount of gain that is realized on the exchange. Additionally, exchanges that have the effect of a dividend distribution can cause all or part of the gain recognized to be treated as a dividend (and reduce earnings and profits). The Green Book asserts that these provisions may permit U.S. taxpayers to repatriate profits from foreign corporations at inappropriately low U.S. tax rates, and notes 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 either the target corporation or the acquiring corporation has earnings and profits that equal or exceed the amount of “boot” distributed. For example, if shares in a foreign corporation with a basis of $200 were exchanged, in a transaction that would otherwise qualify as tax-free, for shares of an acquiring foreign corporation worth $100 and $100 of cash, the recipient would not recognize any gain, even if the $100 of cash were supported by the acquiring foreign corporation’s earnings and profits. Accordingly, the Green Book proposal would repeal the “boot within gain limitation” with respect to reorganizations in which the exchange has the effect of a distribution of a dividend. The Green Book proposal would be effective for taxable years beginning after December 31, 2013.

b. Non-qualified Preferred Stock

Under current law, non-qualified preferred stock (“NQPS”) is treated as boot in corporate capitalization transactions under Code Section 351 as well as in connection with certain shareholder exchanges pursuant to tax-free reorganizations. According to the Green Book, the special treatment accorded to

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22 See Code Section 356(a)(1).
23 See Code Section 356(a)(2).
24 Non-qualified preferred stock is stock that is (i) limited and preferred as to dividends and does not participate in corporate growth to any significant extent and (ii) has a dividend rate linked to an index, or, in certain circumstances, a put right, call right, or a mandatory redemption feature. See Code Section 351(g).
NQPS has led to the exploitation of NQPS for corporate planning transactions (e.g. using NQPS to trigger loss recognition or to avoid treating a related-party stock sale as a dividend) while also proving a trap for the unwary and adding unnecessary complexity to the Code. Accordingly, the Green Book proposal would repeal the NQPS designation and other cross-referencing provisions of the Code that treat NQPS as boot. This proposal would go into effect with respect to stock issued after December 31, 2013.

13. Disallowance of Deduction for Punitive Damages

Under current law, a deduction is generally 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 or punitive. In contrast, fines, similar penalties and amounts paid to governments and governmental agencies in respect of certain judgments are not deductible.\(^{25}\)

The Green Book proposal 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. The Green Book proposal would apply to punitive damages paid or incurred after December 31, 2014. The Green Book proposal is not clear whether this disallowance would also apply to any punitive damages paid after December 31, 2014, if attributable to events occurring before this date.

14. 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.\(^{26}\) With respect to a separate account, the DRD is allowed only to the extent of the life insurance company’s “share” of the dividends 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.\(^{27}\)

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

\(^{25}\) See Code Sections 162(f) and (g).

\(^{26}\) See generally Code Section 817(c). For purposes of Code Sections 801-818 (excluding Code 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.

\(^{27}\) See Code Section 812(a)(1).
insurance contracts from the net investment income.\textsuperscript{28} 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.\textsuperscript{29} The Administration expresses concern that this formula will, in many cases, overstate the company’s actual economic interest in a separate account’s investment income.

The Green Book proposal would repeal the existing method for prorating investment income between the “company’s share” and the “policyholders’ share,” and instead subject the general account DRD, tax-exempt interest and increases in certain policy cash values of a life insurance company to a fixed 15 percent proration, in a manner similar to the proration method used by non-life companies with respect to tax-exempt and similar income. The Green Book states that the proposal would put the company’s general account DRD on a similar footing to that of a non-life company.

The Green Book proposal would also extend the DRD limitations applicable to other corporate taxpayers to cover life insurance company separate account dividends in the same proportion as the mean of reserves bears to the mean of total assets of such account. The Green Book proposal states that the proposal would put the company’s separate account DRD on a similar footing to that of any other taxpayer with a diminished risk of loss in stock that it owns, or with an obligation to make related payments with regard to dividends.

The Green Book proposal would be effective for taxable years beginning after December 31, 2013.

\textsuperscript{28} See Code 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. Code Section 812(b) further provides that policy interest consists of the sum of the following items: (1) “required interest” for reserve items described in Code 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. Code 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.

\textsuperscript{29} Under current law, ER is the interest rate used in determining the contract’s reserve. See Code Section 807(d). Such interest rate can be either (1) the greater of the applicable federal interest rate or the prevailing state-issued interest rate for the contract or (2) another appropriate rate. See Code 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 Internal Revenue Service Letter Ruling 200339049 (August 20, 2002).
15. 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 insures the life of a “key person” of the business (which includes a 20-percent owner of the business, as well as a limited number of the business’ officers or employees). In addition, the interest deduction of a business other than an insurance company is 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. Similar rules apply to life and non-life insurance companies.

The Green Book asserts that both of these exceptions to the interest deduction disallowance rule provide leveraged businesses with tax-exempt or tax-deferred income funded by deductible interest expenses. The Green Book proposal would repeal these exceptions for contracts issued after December 31, 2013. 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.

16. Repeal the Preferential Dividend Rule for Publicly Traded Real Estate Investment Trusts ("REITs") and Publicly Offered REITs

Current law allows REITs a deduction for dividends paid to their shareholders, so long as the dividend is not a “preferential dividend." The Green Book states that, in the context of publicly traded REITs and “publicly offered” REITs, the rule on preferential dividends neither prevents tax avoidance nor ensures fairness among shareholders and that, on the contrary, the rule produces harsh results for inadvertent deviations.

The Green Book proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs in taxable years beginning after the date of enactment. The Green Book proposal would define a “publicly offered” REIT as a REIT (i) that is required to file annual and periodic SEC reports, (ii) not more than one third of whose voting power is held directly or indirectly by a single person (taking into account the attribution rules of Code Section 318), and (iii) whose stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period.

See Code Section 264.

See id.

See Code Section 562(c). The limitation on preferential dividends for regulated investment companies was repealed in 2010.
17. Repeal of Certain Oil and Gas Company Preferences

The Green Book proposal would repeal certain tax preferences for oil and gas companies that exist under current law. In particular, the Green Book proposal 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 natural gas properties with respect to which the owner has not limited its liability, (6) disallow percentage depletion with respect to oil and natural gas wells, and instead require cost depletion, (7) end the domestic manufacturing deduction for oil and natural gas companies, 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.

18. Modify Rules that Apply to Sales of Life Insurance Contracts

The seller of a life insurance contract generally must report as taxable income the difference between the amount received from the buyer and the adjusted basis in the contract. Additionally, persons engaged in a trade or business are generally required to report payments of premiums, compensations, remunerations, other fixed or determinable gains, profits and income to the Internal Revenue Service. This reporting may not be required in some circumstances involving the purchase of a life insurance contract.

Current law also contains a transfer-for-value rule, where the buyer of a previously issued life insurance contract who subsequently receives a death benefit is generally subject to tax on the difference between the death benefit received and the sum of the amount paid for the contract and premiums paid by the buyer, but this rule does not apply if the buyer’s basis is determined by reference to the seller’s basis or if the buyer is the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer.

33 See Rev. Rul. 2009-13, I.R.B. 2009-21, in which the Internal Revenue Service analyzed two life insurance sale situations and determined that the proceeds from selling a life insurance policy are taxable to the seller to the extent they exceed the seller’s adjusted basis in the contract.

34 See generally Code Sections 6041A and 6042.

35 See, e.g., Code Section 6050V(d)(2)(B), which excepts applicable exempt organizations from reporting acquisitions of life insurance contracts in cases of persons with an insurable interest in the insured independent of the applicable exempt organization, named beneficiaries, or in limited circumstances, trust beneficiaries or trustees.

36 See Code Section 101(a)(2).
The Green Book proposal would require a person or entity that purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000 to report the purchase price, the buyer’s and seller’s taxpayer identification numbers, and the issuer and policy number to the Internal Revenue Service, the insurance company that issued the policy, and to the seller. The Green Book proposal would also modify the transfer-for-value rule so as not to except buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's tax identification number, and the insurance company's estimate of the buyer's basis to the Internal Revenue Service and to the payee.

The Green Book proposal would apply to sales or assignments of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2013.

19. 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. 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”).

The Green Book proposal would require life insurance companies to report certain information to the Internal Revenue Service 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. The Green Book would define a “private separate account” for this purpose as any account with respect to which a related group of persons owns policies whose cash values, in the aggregate, represent at least 10 percent of the value of the separate account. The Green Book asserts that this provision will enable the Internal Revenue Service to identify which variable life insurance contracts should be disregarded under the investor control doctrine. The Green Book proposal, if enacted, would require such reporting for any account in which a related group of persons owns policies whose cash values, in the aggregate, represent at least 10% of the value of the separate account. The Green Book proposal would be effective for taxable years beginning after December 31, 2013.

37 See generally Code Section 817.
20. Extension of Statute of Limitations in Connection with State or Local Tax Liability Adjustments

Generally, the imposition of additional U.S. federal income tax liabilities is subject to a three-year statute of limitations (which can be extended in certain circumstances).\textsuperscript{39} The Green Book proposal would create a new exception to the three-year statute of limitations for the 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 Internal Revenue Service reflecting adjustments to the state or local tax return, or (2) two years from the date the Internal Revenue Service first receives information from the state or local revenue agency under an information-sharing agreement in place between the Internal Revenue Service 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 additional amended returns for the same tax periods as the initial amended return or if the Internal Revenue Service 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. The Green Book proposal would be effective for returns required to be filed after December 31, 2013.

21. Extension of Temporary Bonus Depreciation for Certain Property in Promise Zones

Current law allows additional first-year depreciation for qualifying investments placed in service in current years to incentivize development. The bonus depreciation deduction equals 50 percent of the cost of qualified property.\textsuperscript{40} 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 and before 2013 and that the taxpayer placed into service before January 1, 2014.\textsuperscript{41} The Green Book proposal would designate 20 “promise zones” throughout the U.S. Qualified property placed in service within one of these zones would be eligible for bonus first-year depreciation of 100 percent of the adjusted basis of the property. This property must be placed in service within the zone while the zone designation is in effect.

\textsuperscript{39} See Code Section 6501.

\textsuperscript{40} See Code Section 168(k). To qualify for the 100\% additional first-year deduction, the property must be acquired after September 8, 2010 and before January 1, 2012, and generally placed in service before January 1, 2012. Code Section 168(k)(5).

\textsuperscript{41} Certain kinds of property (in general, property with a recovery period of ten years or longer and certain transportation property and aircraft) are granted a one-year extension of the placed-in-service date (January 1, 2013 for the 100\% deduction and January 1, 2014 for the 50\% depreciation deduction).
22. Elimination of Capital Gains Taxation on Investments by Non-Corporate Taxpayers in Small Business Stock

The Creating Small Business Jobs Act of 2010\(^42\) provided that non-corporate taxpayers may exclude 100% of the gain from the sale of qualified small business stock acquired after September 27, 2010 and before January 1, 2011 (subsequently extended to January 1, 2012\(^43\) and further extended to January 1, 2014)\(^44\) where the stock is held for at least five years and certain other requirements are met.\(^45\) 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). A related provision allows investors that sell qualified small business stock held over six months to defer recognition of capital gain by reinvesting the sales proceeds in new qualified stock within 60 days.\(^46\) Under this rollover provision, the investor's basis in the new stock is reduced by the amount of the deferred gain.

The Green Book proposal would make the 100% small business stock exclusion permanent and eliminate the alternative minimum tax preference item for gains excluded under this provision. The Green Book proposal would also add a new six month rollover period, in addition to the current 60-day rollover period, for taxpayers to reinvest the proceeds from sales of qualified small business stock held longer than three years. The Green Book proposal also specifies that taxpayers would be required to report qualified sales on their tax returns. This proposal would be effective for qualified small business stock acquired after December 31, 2013.

23. Enhance and Make Permanent the Research and Experimentation Tax Credit

The Green Book proposal would increase the rate of the alternative simplified research credit from 14% to 17% and make permanent the research and experimentation tax credit, which is currently scheduled to expire on December 31, 2013.\(^47\) The proposal would be effective after December 31, 2012.

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\(^{42}\) Pub. L. No. 111-240.


\(^{44}\) See the American Tax Relief Act of 2012, Pub. L. No. 112–240.

\(^{45}\) See Code Section 1202(c).

\(^{46}\) See Code Section 1045.

\(^{47}\) See Code Section 41(h).
President Obama’s Fiscal Year 2014 Revenue Proposals
April 16, 2013
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