# Washington Update: Current Legislative, Regulatory and Administrative Developments

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## I. Introduction

### A. The Current Environment

1. These are challenging times, with continuing uncertainty and change. There is continuing uncertainty in the area of taxation, including federal, state and local taxation and taxation by foreign governments.
2. It is important for practitioners and clients to understand economic and business trends, as well as trends in taxation, to obtain an appreciation of where and when to expect changes.
3. In addition, it is important for practitioners and clients to be aware of specific changes that governments are considering, so that practitioners and clients can anticipate the changes and plan accordingly. If practitioners and clients know of changes before they go into effect, they could have the opportunity to take actions to help mitigate the potential effect of the changes.
4. After changes go into effect, practitioners and clients will need to take steps to comply with and adjust to the changes.

## II. Trends in Taxation

### A. Increased Cross-Border Activity

1. Cross-border activity economic activity is rapidly increasing. This activity crosses local, state and international borders. Cross-border trade into and out of the United States is growing dramatically. Future growth for many U.S. companies is likely to be greatest in emerging markets such as China, Brazil and India.
2. Capital, intellectual property/intangibles and people are increasingly mobile. Advances in technology, communications and transportation have dramatically reduced the cost and time to move capital, information, goods and people.
3. Economies and transactions are becoming increasingly complex.

## B. Pressures on Governments

1. Governments are attempting to keep up with the volume and complexity of economic activity and law.
2. Governments are seeking more revenue as a result of spending needs and deficits. The 2008 financial crisis resulted in more government spending and less tax revenues. The budget deficit for the United States for the fiscal year ended September 30, 2009 was $1.4 trillion, for FY 2010 was $1.3 trillion, for FY 2011 was $1.3 trillion, and for FY 2012 was $1.1 trillion. The estimated deficit for FY 2013 is $850 billion. Substantial federal deficits are expected for many years to come.
3. Political leaders are calling on high-income individuals and corporations to "pay their fair share". In September 2012, Senator Carl Levin, Chairman of the Senate Permanent Subcommittee on Investigations, held a hearing criticizing tax planning techniques used by multinational corporations. In January 2013, in a speech at the World Economic Forum in Davos, Prime Minister David Cameron of the United Kingdom called for concerted action to address tax avoidance by businesses. In his State of the Union Address in February 2013, President Obama said that to achieve the U.S. deficit reduction target, the United States should adopt a balanced approach, with spending cuts and revenues, that eliminates tax loopholes and special interest tax breaks.
4. As evidenced by the summer 2011 debate about the federal debt ceiling, the 2012 debate about the fiscal cliff, and the 2013 debate about the sequester and the continuing resolution to fund the federal government, there is disagreement about how to address U.S. fiscal challenges. There is a consensus that the primary causes of increasing spending are the aging of the U.S. population and healthcare costs, which are driving up the costs of entitlement programs such as Social Security, Medicare and Medicaid. Republicans in Congress want to address our challenges by reducing spending. The Obama Administration and Democrats in Congress want to address our challenges by a combination of spending reductions and increased taxes on higher-income individuals.
5. Governments have fewer resources, so they must become more efficient in revenue collection.
   a. Tax authorities are seeking better risk assessment models.
   b. Tax authorities desire more streamlined dispute resolution. For example, the IRS has initiated programs such as Pre-Filing Agreements, Advanced Pricing Agreements, Fast Track Settlement and early referral to Appeals.
   c. Tax authorities are requiring more taxpayer disclosure and transparency. For example, over the last decade, the IRS has required disclosure of reportable transactions and has implemented Schedule M-3 requiring disclosure of book-tax differences. More recently, the IRS has created a schedule to require corporations to disclose uncertain tax positions (UTPs). A UTP is a tax position for which the corporation has recorded a reserve with respect to the position in audited financial statements, or a tax position for which the corporation did not record a reserve for the position because the corporation expects to litigate the position. The schedule requires taxpayers to rank its

UTPs by size, and provide a concise description of each position, including a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue. This schedule became effective for corporations with assets exceeding $100 million for returns filed for 2010, for corporations with assets exceeding $50 million for returns filed for 2012, and will become effective for corporations with assets exceeding $10 million for returns filed for 2014. The IRS has stated that its goals for this program are certainty, consistency and efficiency. UTP filings are sent to a centralized unit, which studies the filings to identify significant issues, including areas that may need to be addressed through published guidance. UTP filings are also provided to examiners. The top three areas for disclosures are transfer pricing, the research credit and business expenses.

## C. More Enforcement by Tax Authorities

1. Because of budgetary challenges, federal, state, local and foreign tax authorities are increasing their focus on enforcement. Governments are increasing their enforcement budgets. The total IRS budget, including for enforcement, is now approximately $12 billion per year.
2. There is substantial concern about the tax gap, which is the amount of taxes not paid that are properly due. Based on a review of 2006 data, the IRS has estimated the net tax gap at $385 billion per year, or about 17% of taxes properly due.
3. Tax authorities are taking stronger measures to obtain information and collect tax from taxpayers who have failed to report income. For example, the IRS is vigorously pursuing individuals who are hiding assets or income outside the United States. The IRS initiated a voluntary disclosure program that closed in October 2009. In addition, as a result of IRS efforts, the Swiss parliament voted to permit the transfer of information to the IRS about 4,450 secret accounts at the Swiss bank UBS. In February 2011, the IRS initiated a second voluntary disclosure program, which closed on September 9, 2011. In November 2012, IRS Commissioner Douglas Shulman announced that IRS efforts have resulted in roughly 38,000 disclosures from taxpayers who have paid more than $5.5 billion in back taxes and penalties. There are continuing cases involving accounts in Switzerland, India, Israel, Hong Kong, Singapore and elsewhere. In January 2013, Wegelin & Co., a Swiss private bank, pleaded guilty to U.S. criminal charges and admitted it helped Americans avoid U.S. taxes.
4. Tax authorities are increasingly taking the position that business taxpayers have sufficient nexus to be taxable in the jurisdiction. For example, in the Vodafone case, Indian tax authorities took the position that the sale of stock of a Cayman Islands corporation that indirectly owned an Indian corporation by a non-Indian seller to a non-Indian buyer was taxable in India. In the United States, state tax authorities are increasingly assertive about asserting nexus to the state.

5. There will be more audits and more controversy. Taxpayers might consider an overall controversy strategy rather than dealing with each controversy on an ad hoc basis.

6. Governments will enact more penalties, and tax authorities will assert penalties more often. For example, in recent years Congress has enacted many new penalties, and in various circumstances has made it difficult for taxpayers to obtain a waiver of penalties. In March 2010, as part of the health care legislation, Congress codified the economic substance doctrine, and enacted a 40% penalty, without a reasonable cause exception, if an undisclosed transaction is found to lack economic substance. The penalty is 20%, without a reasonable cause exception, if the transaction is disclosed.

## D. Enhanced Cooperation Among Tax Authorities

1. Information sharing among tax authorities will increase, and increasingly will be done on an automatic basis, as opposed to on request. This includes sharing between the IRS and foreign tax authorities, as well as sharing between the IRS and state tax authorities. The United States has entered into more than 60 tax treaties providing for sharing of tax information and more than 25 tax information exchange agreements.

   a. In March 2010, Congress enacted the Foreign Account Tax Compliance Act (FATCA, which was part of the Hiring Incentives to Restore Employment Act of 2010, Public Law 111-147) to require foreign financial institutions to report to the IRS information about financial accounts held by U.S. taxpayers.

      In connection with the February 2012 release of proposed regulations under FATCA, the Treasury Department released a joint statement with France, Germany, Italy, Spain and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA. The parties to the statement committed to working with each other, the Organisation for Economic Cooperation and Development (OECD), and where appropriate the European Union, on adapting FATCA to a common model for automatic exchange of information. The February joint statement with the five European countries contemplated reporting by foreign financial institutions to their own governments, followed by the transfer of this information to the United States.

      In June 2012, the Treasury Department issued two more joint statements on intergovernmental cooperation to facilitate compliance with FATCA, one with Japan and the other with Switzerland. The June 2012 joint statements outline a second approach to reporting, whereby the foreign financial institutions would report information directly to the United States.

      In July 2012, the Treasury Department published a model intergovernmental agreement to implement FATCA. This agreement (Model I) was developed in consultation with the five European countries that participated in the February 2012 joint statement, and contemplated reporting by financial institutions to their own governments, followed by the transfer of this information to the United States. In September 2012, the United States and the United Kingdom signed the first intergovernmental agreement (IGA), under Model I. In November 2012, the Treasury Department published a second model agreement, which contemplated direct reporting by financial institutions to the United States (Model II). In January 2013, Treasury/IRS issued final regulations implementing FATCA. In February 2013, the United States and Switzerland signed the first Model II IGA. The United States has signed IGAs with several other countries and is negotiating IGAs with numerous other countries.

2. Tax authorities will conduct simultaneous or joint audits. A simultaneous audit is where two jurisdictions audit a taxpayer separately at the same time. A joint audit is where two jurisdictions audit a taxpayer together. The IRS has started some joint audits with foreign revenue authorities. One joint audit involving a transfer pricing issue resolved the issue for the current year and resulted in a bilateral advance pricing agreement for future years.

3. Multilateral cooperation about tax issues will increase.

   a. For example, the Organisation for Economic Cooperation and Development (OECD) is a group of 34 countries that provides a forum where governments compare and exchange policy views, identify best practices and make recommendations. The OECD's work in the tax area is carried out by the Committee on Fiscal Affairs (CFA), which recommends standards for international tax policy and administration. The CFA's work agenda is carried out by various working groups, including the Forum on Tax Administration (FTA), which brings together tax commissioners from countries around the world to share ideas on how to improve tax administration. The OECD's Model Tax Convention has been used as the basis for many tax treaties and its Transfer Pricing Guidelines have been used as the basis for legislation in various countries.

   b. In February 2013, the OECD issued a report entitled "Addressing Base Erosion and Profit Shifting" (BEPS). The report concludes that base erosion is a serious risk to tax revenue, tax sovereignty and tax fairness for countries around the world. A significant source of base erosion is profit shifting. The report observes that international principles to share tax jurisdiction may not have kept pace with the changing business environment. Rules for international taxation are still grounded in a lower degree of economic integration across borders, rather than today's environment of global taxpayers, with the increasing importance of intellectual property and constant developments in information and communication technologies. Tax systems of countries not only can result in double taxation that should be alleviated, but they can also leave gaps that multinational corporations can exploit to eliminate or significantly reduce taxation in a manner inconsistent with domestic and international standards. In addition to supporting increased transparency about effective tax rates of multinational corporations, the report identifies key pressure areas, including:

(i) International mismatches in entity and instrument characterization;

(ii) Application of treaty concepts to profits derived from the delivery of digital goods and services;

(iii) The tax treatment of intra-group financial transactions;

(iv) The effectiveness of anti-avoidance measures; and

(v) The availability of harmful preferential regimes.

The report observes that the tax practices of some multinational corporations have become more aggressive over time. Current international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy. As businesses increasingly integrate across borders and tax rules remain uncoordinated, there are a number of structures, technically legal, which take advantage of asymmetries in domestic and international tax rules. The current rules provide opportunities to associate more profits with legal constructs and intangible rights and obligations, and to legally shift risk intra-group, with the result of reducing the share of profits associated with substantive operations.

The report concludes that a holistic approach is necessary to properly address the issue of BEPS. Government actions must be comprehensive and deal with all the different aspects of the problem. In addition, because BEPS strategies take advantage of the interface between the tax rules of different countries, it may be difficult for any single country, acting alone, to fully address the issue. Furthermore, unilateral and uncoordinated actions by governments responding in isolation could result in the risk of double taxation. Consequently, there needs to be an internationally coordinated approach with comprehensive international solutions.

In the report the OECD commits to preparing a global and comprehensive action plan, which will be completed by June 2013 and will (i) identify actions needed to address BEPS, (ii) set deadlines to implement these actions; and (iii) identify the resources needed and the methodology to implement these actions. The action plan will include proposals regarding:

(i) Methods to address hybrid mismatch arrangements and arbitrage;

(ii) Improvements or clarifications to transfer pricing rules, including rules about intangibles;

(iii) Updated solutions to issues related to jurisdiction to tax, in particular in the areas of digital goods and services;

(iv) More effective anti-avoidance measures;

(v) Rules on the treatment of intra-group financial transactions; and

(vi) Solutions to counter harmful regimes more effectively.

c. Another example of multilateral cooperation is the Joint International Tax Shelter Information Centre (JITSIC). JITSIC is an initiative begun in 2004 by the United States, the United Kingdom, Australia and Canada to curb abusive tax avoidance transactions and enhance activities against cross-border transactions involving tax compliance risk. It has been reported that JITSIC helped identify foreign tax credit generator transactions that the IRS has challenged. JITSIC has expanded its portfolio to include tax administration issues arising from the global economic environment and financial crisis, use of offshore arrangements to avoid tax, arrangements used by high wealth/income individuals to minimize their tax liabilities, and tax administration approaches and activities to improve transfer pricing compliance.

## E. Tension Between Cooperation and Competition

Local, state, federal and foreign jurisdictions want to attract businesses and investment. More business activity leads to more jobs, more income and more tax revenues. So while tax authorities will cooperate to collect revenues, their lawmakers will enact tax incentives to attract business activity. For example, a local government might grant a real property tax holiday for a business to locate there. The Internal Revenue Code has various provisions, such as the portfolio interest exemption, to encourage foreigners to invest in the United States. Countries have or are considering "patent box" regimes, which impose lower taxes on income from intangible property, to encourage businesses to move or keep their intangibles in the country. National competitive interests will continue to motivate countries to take actions to attract business and investment.

## F. Stimulus Versus Austerity

Governments initiated many economic stimulus programs to address the 2008 financial crisis and the recession. The programs included temporary tax incentives. Lawmakers may be reluctant to end programs once established, but renewing the programs adds to budget deficits. Lawmakers need to determine when and how to wind down stimulus programs while avoiding potential negative economic effects of withdrawing the stimulus. An example of the difficulty of this issue is the federal payroll tax holiday that reduced the employee payroll tax rate by two percentage points from 6.2% to 4.2%. The purpose of the provision was to provide temporary assistance to American workers. This provision was initially enacted in December 2010 (in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010), was extended in December 2011 and again in February 2012, and expired at the end of 2012. European countries have decided that austerity measures to address budgetary imbalances are more important than stimulus, and these austerity measures have had detrimental economic effects, at least in the short term.

## G. Legislative Consideration of Spending Reductions and Tax Increases

1. Because of budgetary pressures, governments need to cut spending, raise taxes, or both. As evidenced by the summer 2011 debate about the federal debt limit, addressing deficits is very difficult. In most jurisdictions government spending continues to rise. At the federal level, within the next couple of decades it is

expected that mandatory spending (on programs such as Medicare, Medicaid, and Social Security, plus interest on the federal debt) alone will exceed federal revenues, which is intensifying the pressure on the need to reduce both discretionary spending (on defense, education, etc.) and mandatory spending. The debt ceiling debate in the summer of 2011 resulted in the enactment of the Budget Control Act of 2011.

a. In February 2010, President Obama signed an executive order creating a bipartisan National Commission on Fiscal Responsibility and Reform. The mission of the Commission was to identify policies to improve the national fiscal situation in the medium term and to achieve fiscal sustainability over the long run. The executive order directed the Commission to propose recommendations to balance the budget, excluding interest payments on U.S. government debt, by 2015 (achieving deficits of about 3% of GDP). The Commission was directed to propose recommendations that meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending. The Commission was chaired by Erskine Bowles (former Clinton White House Chief of Staff) and Alan Simpson (former Republican Senator from Wyoming). The Commission issued its report in December 2010. Eleven of the 18 members of the Commission approved the report. The report proposed substantial spending reductions and an overall tax increase. The report recommended eliminating or curtailing all tax expenditures, lowering individual and corporate tax rates, and adopting a territorial tax system. The report did not recommend a new revenue source, such as a value-added tax (VAT).

b. In addition, in August of 2010 the tax reform subcommittee of the President's Economic Recovery Advisory Board (PERAB) submitted a report of options to simplify the tax system, improve compliance, and reform the corporate tax system. PERAB is an outside advisory panel and not part of the Obama Administration. PERAB was not asked to and did not recommend a major overarching tax reform or a VAT in addition to or in lieu of the current income tax system.

c. The Budget Control Act of 2011, signed by President Obama on August 2, 2011, raised the federal debt limit and reduced the federal deficit by $917 billion over 10 years through caps on discretionary spending for FY 2012 through FY 2021. The Budget Control Act also created a 12-member Joint Select Committee on Deficit Reduction that was charged with producing recommendations, including legislative language, to reduce the deficit by an additional $1.2 trillion in the 10-year period. The Committee was chaired by Senator Patty Murray (D-WA) and Congressman Jeb Hensarling (R-TX). The Committee had three Senate Democrats (Senators Murray, Max Baucus (MT) and John Kerry (MA)), three Senate Republicans (Senators John Kyl (AZ), Rob Portman (OH) and Pat Toomey (PA)), three House Democrats (Congressmen James Clyburn (SC), Xavier Becerra (CA) and Chris Van Hollen (MD)), and three House Republicans (Congressmen Hensarling, Dave Camp (MI) and Fred Upton (MI)). Under the Budget Control Act, the Committee was required to vote by November 23, 2011, on (i) a report that included a detailed statement of findings, conclusions and recommendations, with a revenue estimate prepared by the Congressional Budget Office, and (ii) legislative language to carry out the Committee's recommendations. If the Committee passed (by a simple majority vote) any recommendations, such recommendations were then to be sent directly to the Senate and House of Representatives for a vote. Amendments to the legislation were not permitted, and a filibuster in the Senate was prohibited. The Senate and House were required to vote on the Committee's recommendations by December 23, 2011. If the Committee actions did not result in a bill being enacted by January 15, 2012, or if legislation produced by the Committee process did not reduce the deficit by $1.2 trillion or more over 10 years, then across-the-board sequestration for FY 2013 and thereafter, split between domestic spending (with certain limitations) and defense spending, would start taking effect at the beginning of 2013 to achieve the $1.2 trillion in savings over 10 years. Sequestration was intended as a draconian mechanism to force Congress to agree to comprehensive long-term solutions to address the federal deficit.

The legislative language in the Budget Control Act that established the Joint Select Committee on Deficit Reduction did not specifically mention the possibility that the recommendations of the Committee and legislative language could include tax changes, but neither did it explicitly prohibit the consideration and inclusion of tax provisions. The Obama Administration and other Democrats said that an increase in tax revenues had to be part of the Committee's recommendations. Republicans said they did not want the Committee to raise taxes.

The Joint Select Committee was unable to reach an agreement before the November 23, 2011 deadline, in significant part because of the disagreement between Democrats and Republicans about raising taxes. As required by the Budget Control Act, spending sequestration was scheduled to take effect at the beginning of 2013, but was postponed until March 1, 2013 in the legislation at the end of 2012 to address the fiscal cliff, discussed below.

Despite a desire to avoid the effects of sequestration, Congress did not act to prevent it from taking effect on March 1. The sequester for FY 2013 is $85.4 billion, half of which will be applied to defense spending and half to non-defense spending. Especially troublesome to lawmakers is the fact that there is little flexibility to decide how to apply the sequester, although there are special rules for various programs and some programs are fully exempt, such as refundable tax credits for individuals. Sequestration will reduce the IRS budget in FY 2013 by about $600 million (5%), including a reduction of $267 million in enforcement.

d. Congress did not pass appropriations bills for FY 2013, so the operations of the federal government were funded by a continuing resolution that was scheduled to expire on March 27, 2013. Without an extension of the continuing resolution, the federal government would have been forced to suspend various activities. Congress averted this possibility by passing an extension of the continuing resolution until September 30, 2013, the end of FY 2013. The continuing resolution is subject to the limitations of the sequester.

e. The battle over the federal debt limit led to the Budget Control Act in 2011. The debt limit was reached again towards the end of 2012, but in January 2013 Congress passed a bill (H.R. 325) that suspended the debt limit until May 19, 2013, and required both Houses of Congress to approve FY 2014 budget resolutions by April 15. Using "extraordinary measures", the Treasury Department can meet all federal financial obligations at least until the end of July 2013. Consequently, it is anticipated that there will be a confrontation over the debt limit this summer, with Republicans insisting on spending reductions as a quid pro quo for agreeing to lift the debt limit.

2. Because of greatly increased revenue needs, governments at all levels are considering tax increases. Difficult questions are what taxes, on whom and how much?

   a. Will legislatures consider more taxes on upper-income taxpayers and businesses? The 2012 negotiations about the fiscal cliff resulted in expiration of the 2001/2003 tax relief for upper income Americans and higher taxes for them, discussed below. The Obama Administration has pledged not to raise taxes on married individuals with income less than $250,000 per year and single individuals with income less than $200,000 per year. The Obama Administration continues to support collecting more taxes from Americans with income above those thresholds. The Obama Administration budget proposal for FY 2014, which was released in April 2013, proposes to collect more in taxes from upper-income individuals by limiting the tax rate at which they can use itemized deductions and other tax preferences to a maximum of 28%. The Obama Administration FY 2014 budget proposal includes a "Buffett rule", under which high earners would pay no less than 30% of their adjusted gross income in taxes (phased in starting at $1 million of adjusted gross income for joint filers and fully phased in at adjusted gross income of $2 million for joint filers). The FY 2014 budget proposal also would restore the estate and gift tax parameters to 2009 levels (a maximum tax rate of 45% and an exemption amount of $3.5 million for estates and $1 million for gifts without indexation for inflation).

   b. The Obama Administration also supports raising taxes on various sectors of business activity. For example, as indicated in the FY 2014 Obama Administration budget proposal, the Administration supports repealing the last-in, first-out (LIFO) accounting method for inventories, supports various changes to the international tax provisions (proposals to defer the deduction of interest expense related to deferred foreign income, determine the foreign tax credit on a pooling basis, and impose tax currently on excess returns associated with transfers of intangibles offshore), supports the repeal of various oil and gas tax incentives, and supports taxing carried interests as ordinary income.

   c. Will legislatures consider more indirect taxes, such as consumption taxes and property taxes? Many experts believe that the income tax and payroll taxes alone cannot supply sufficient revenue to fund the needs of the federal government. Unlike the vast majority of countries around the world, the

United States does not have a VAT. In April of 2010 Paul Volcker, chairman of PERAB, suggested that a VAT in the United States is "not as toxic an idea" as it once was. However, on April 15, 2010, the Senate, by a vote of 85-13, adopted a resolution that a VAT "is a massive tax increase that will cripple families on a fixed income and only further push back America's economic recovery."

# III. The Results of the Negotiations About the Fiscal Cliff

## A. The American Taxpayer Relief Act of 2012

1. The United States faced a fiscal cliff at the end of 2012. If Congress had failed to act, various provisions, including tax provisions, would have expired, with potentially substantial detrimental economic consequences. The American Taxpayer Relief Act of 2012 (ATRA) (Public Law 112-240), signed by President Obama on January 2, 2013, resolved and provided certainty with respect to several important issues that were part of the fiscal cliff negotiations. Those issues included:
    a. The 2001/2003 tax relief would have expired at the end of 2012. ATRA permanently extended the 2001/2003 individual income tax rates for lower and middle income taxpayers having taxable income below a threshold amount. For taxable incomes above the threshold amount, the 39.6% rate which applied before the 2001/2003 tax relief applies. The threshold amounts are $450,000 in the case of a joint return and $400,000 in the case of a single individual (indexed for inflation). ATRA also permanently extended the maximum tax rate on long-term capital gains and qualified dividends at 15%, except for higher income individuals the rate is increased to 20%. ATRA also permanently extended many other provisions of the 2001/2003 tax relief, including, for example, the 10% bracket, marriage penalty relief, and the enhanced child tax credit.
    b. The alternative minimum tax (AMT) "patch" would have expired at the end of 2011, subjecting more than 20 million additional taxpayers to the AMT in 2012 and subsequent years. Congress periodically enacts a "patch" to the alternative minimum tax (AMT) that increases the exemption amount (which is not otherwise indexed to inflation) and allows the use of certain personal credits against AMT liability. ATRA permanently enacted an AMT patch, indexed for inflation.
    c. The maximum estate tax rate would have risen from 35% for decedents dying in 2012 to 55% for decedents dying thereafter, and the exemption amount would have fallen from $5.12 million for decedents dying in 2012 (with portability of the unused exclusion between spouses) to $1 million for decedents dying thereafter (with no portability). ATRA made permanent the 2012 estate and gift provisions, except with a 40% maximum estate and gift tax rate.
    d. The employee payroll tax holiday, previously discussed, was scheduled to expire at the end of 2012, but it was uncertain whether it would be extended again. It was enacted in 2010 and extended twice. There was uncertainty

whether it would be extended a third time into 2013. It was not extended in ATRA.

e. The baseline for measuring the revenue impact of future tax changes would have remained uncertain. As long as the fate of the 2001/2003 tax relief was uncertain, revenue estimators were uncertain about the revenue baseline. By making permanent various important provisions in ATRA, the revenue baseline became more certain. Nevertheless, not everything was resolved and made permanent, such as certain 2009 tax provisions to aid low income individuals (which were extended through 2017), expanded unemployment benefits and Medicare physician payments (which were extended to the end of 2013), and tax extenders, discussed below.

f. Also note that, under the 2010 Affordable Care Act, beginning in 2013 individuals are subject to an additional Medicare tax of 0.9% on wages over $250,000 for joint returns and $200,000 for single individuals. In addition, individuals are subject to an additional Medicare tax of 3.8% on the lesser of net investment income (e.g., interest, dividends, capital gains and certain types of business income) or the excess of modified adjusted gross income over $250,000 for joint returns and $200,000 for single individuals.

### B. Expiring Provisions

Approximately 50 temporary provisions were scheduled to expire at the end of 2011, including, for example, 100% depreciation, the deduction for state and local general sales taxes, the research credit, 15-year straight-line cost recovery for qualified leasehold, restaurant and retail improvements, and the subpart F active financing and look-through rules. Congress frequently struggles to enact extenders legislation. For example, in December 2010, Congress extended provisions that expired at the end of 2009 (a two-year extension through the end of 2011). Numerous temporary provisions are intended to provide an incentive effect, and the incentive effect can be diminished if the incentive is enacted retroactively. In 2011 Congress did not deal with extenders that expired at the end of 2011 (other than employee payroll tax relief). In ATRA, Congress extended many provisions for two years through 2013. The debate about extenders for 2014 and thereafter (and expended unemployment benefits and Medicare physician payments) will be renewed at the end of this year. As it has in the past, Congress will debate whether various extenders have sufficient continuing merit to be extended again.

## IV. Tax Reform

### A. Background

1. Over the past several years there has been much discussion of federal tax reform. For example, in November 2005, the President's Advisory Panel on Federal Tax Reform issued a report, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System". In 2007, Congressman Rangel, who was then chairman of the House Ways and Means Committee, introduced tax reform legislation (H.R. 3970). In 2010 Senators Wyden and Gregg introduced a tax reform bill (S. 3018).

2. Some of the objectives stated for tax reform are collection of sufficient revenue to fund the government, economic growth, minimization of economic distortions caused by the tax system, simplicity, administrability, stability, and fairness.
3. The Obama Administration and other Democrats believe that tax reform should raise more revenue than the current system in order to help address our country's budget imbalance. Republicans generally believe that tax reform should not raise more revenue than our current system.
4. The Senate Finance Committee and the House Ways and Means Committee have held numerous hearings about various aspects of tax reform.
5. As indicated previously, in February 2010, President Obama signed an executive order creating a bipartisan National Commission on Fiscal Responsibility and Reform. The Commission, which was chaired by Erskine Bowles and Alan Simpson, was directed to propose recommendations to improve the nation's long-run fiscal outlook. The Commission issued its final report in December 2010. The report proposed substantial spending reductions and an overall tax increase. The report recommended eliminating or curtailing all tax expenditures, lowering individual and corporate tax rates, and adopting a territorial tax system.
6. The Obama Administration has expressed a desire for tax reform. In its budget proposal for FY 2013 (chapter 15 of Analytical Perspectives), the Obama Administration stated that two of the biggest economic challenges facing the United States, creating jobs and reducing long-term deficits, depend on a tax system that is fairer, simpler, and more efficient than our current system. The Obama Administration called for fundamental tax reform that meets five key principles:
    a. Simplify the tax code and lower tax rates;
    b. Reform inefficient and unfair tax breaks, including getting rid of subsidies for millionaires that they do not need and ensuring at least as good a deal for middle-class Americans as for wealthy Americans;
    c. Decrease the deficit by $1.5 trillion while protecting progressivity;
    d. Increase job growth and creation in the United States; and
    e. Observe the Buffett rule so that those making over $1 million pay no less than 30% of their income in taxes.

## B. Business Tax Reform

1. The Obama Administration has expressed support for corporate income tax reform. Recognizing that the U.S. statutory corporate income tax rate is higher than the rate in nearly all other developed countries, the Obama Administration has expressed support for lowering the corporate tax rate and broadening the corporate tax base, on a revenue neutral basis. Commentators have observed, however, that although eliminating all corporate tax expenditures would result in lowering the rate by several percentage points, the United States would continue to have a higher rate than most other countries. In addition, the states also impose corporate income taxes, increasing the total corporate tax rate.

2. On February 22, 2012, the Obama Administration released "The President's Framework for Business Tax Reform", a joint report by the White House and the Treasury Department. The framework is intended to be revenue neutral within business tax reform. The framework, which applies not only to corporations but to all businesses, has five elements:

    a. Eliminate numerous business tax expenditures and reduce the corporate tax rate to 28%, including various proposals that are included in the Obama Administration budget proposal for FY 2013, plus options to lengthen depreciation, reduce the deductibility of interest for corporations, create greater parity between the taxation of large corporations and large noncorporate entities, reduce the disparity between book income and taxable income, and require greater disclosure of annual income tax payments;

    b. Refocus the §199 manufacturing deduction and reduce the effective corporate tax rate on manufacturing to 25% (and even lower for advanced manufacturing), expand, simplify and make permanent the research credit, and extend, consolidate and enhance key tax incentives for clean energy;

    c. Strengthen the international tax system by requiring corporations to pay a minimum tax on overseas profits, remove tax deductions for moving production overseas, provide new incentives for bringing production back to the United States, and reduce incentives to shift income and assets overseas, including taxing currently the excess profits associated with shifting intangibles to low-tax jurisdictions, and requiring that the deduction for the interest expense attributable to overseas investment be delayed until the related income is taxed in the United States;

    d. Cut taxes for small businesses, including permanent expensing of up to $1 million of qualified investments and allowing cash accounting for businesses with up to $10 million in gross receipts; and

    e. Restore fiscal responsibility and not add to the deficit (including by either eliminating or making permanent and fully paying for expiring provisions).

3. The Obama Administration budget proposal for FY 2014 reiterates support for revenue-neutral business tax reform. The budget proposal offers a collection of business provisions, such as incentives for manufacturing, research, small businesses, and regional growth. It also includes revenue raisers to help pay for business tax reform. The total package of business provisions raises a net amount of $95 billion over 10 years, which by itself would not allow the business tax rate to drop significantly on a revenue-neutral basis. The budget proposal does not include other revenue raisers to pay for a more substantial reduction in the business tax rate. The business revenue raisers are not counted toward meeting the Obama Administration's deficit reduction goals.

4. An issue raised by business tax reform and not directly addressed in the President's Framework is the potential effect on owners of pass-through entities (partnerships, limited liability companies and S corporations) and sole proprietorships. A large portion of U.S. business is conducted by pass-through entities and sole proprietorships. Many business owners select these forms of organization in part to avoid having to pay a corporate tax. Would tax reform

eliminate tax expenditures for all businesses, harming the owners of pass-through entities and sole proprietorships? The President's Framework would eliminate numerous business tax expenditures, but would not lower the tax rate on owners of pass-through entities and sole proprietorships. Indeed, with the support of the Obama Administration, ATRA increased tax rates on high income individuals, including individual owners of pass-through entities and sole proprietorships.

5. Corporate income tax results in double taxation, once on a corporation's earnings and a second time when shareholders receive dividends or sell their stock. Corporate income tax reform might provide the opportunity to address some of the effects of the corporate income tax, such as the incentive to use a pass-through entity or sole proprietorship rather than a corporation, the incentive to use debt financing rather than equity financing, and the incentive for a corporation to retain earnings rather than pay dividends.

## C. International Tax Reform

1. Corporate income tax reform would also provide an opportunity to address the U.S. international tax system. The current U.S. international tax system is a worldwide system, in which global income of a U.S. corporation is subject to U.S. taxation. However, taxation of active foreign earnings of foreign subsidiaries is deferred until the earnings are repatriated from the foreign subsidiaries to the United States, and there is a foreign tax credit allowed for foreign taxes that were paid on those active foreign earnings. Commentators observe that because of the residual U.S. tax on repatriation of foreign earnings (i.e., in excess of available foreign tax credits), corporations are reluctant to bring back foreign earnings. It is estimated that U.S. corporations are retaining approximately $1.7 trillion in foreign earnings in foreign subsidiaries.

2. Some U.S. corporations have urged Congress to enact a repatriation provision similar to §965, which was enacted in the American Jobs Creation Act of 2004 and provided a temporary 85% dividends received deduction to U.S. corporations repatriating dividends from controlled foreign corporations. These corporations have urged Congress to enact another repatriation provision regardless of whether corporate tax reform moves forward. In April 2011, the staff of the Joint Committee on Taxation estimated that a stand-alone proposal to provide another temporary 85% dividends received deduction would cost $78.7 billion in revenue over 10 years. The Obama Administration has indicated that it would consider a repatriation provision only in the context of overall corporate tax reform. At present there is no momentum in Congress to enact a standalone repatriation provision.

3. Commentators assert that because of the high U.S. statutory corporate income tax rate, U.S. companies are at a competitive disadvantage compared to foreign competitors. Reducing the U.S. corporate income tax rate would help U.S. corporations to invest in the United States and abroad, and would encourage foreign corporations to invest in the United States. Reducing the U.S. corporate income tax rate would also help address other issues, such as transfer pricing, because there would be less incentive for U.S. corporations to locate their earnings abroad.

4. A critical issue in the corporate tax reform debate will be the structure of the U.S. international tax system. Most other countries in the world use a territorial system of taxation, in which active offshore earnings are not subject to home country tax when repatriated. Many commentators argue that the United States should adopt a territorial system, because U.S. corporations are increasingly finding that their growing markets are overseas and a territorial system is necessary for U.S. corporations to compete with foreign competitors in those markets. The Obama Administration has substantial concerns about moving to a territorial system, in part because of fears that it will increase the incentive for U.S. corporations to move operations and profits abroad, reducing U.S. employment and reducing corporate tax revenues. As stated in The President's Framework for Business Tax Reform, "a pure territorial system could aggravate, rather than ameliorate, many of the problems in the current tax code. If foreign earnings of U.S. multinational corporations are not taxed at all, these firms would have even greater incentives to locate operations abroad or use accounting mechanisms to shift profits out of the United States. Furthermore, such a system could exacerbate the continuing race to the bottom in international tax rates."
5. The debate about the U.S. international tax system is ongoing. As this debate continues, it will be critical to discuss and debate the details of a potential territorial tax system. What offshore earnings would be exempt from U.S. taxation? Only repatriated dividends, and not inbound payment of royalties or interest (that might be deductible in the payor's country)? What deductions, if any, would be disallowed as attributable to exempt foreign income? In other words, would there be an allocation of expenses, such as interest, to exempt foreign income and the allocated expenses would be nondeductible? Or, as in other countries, would there be no expense allocation, but as a substitute for expense allocation would there be a reduction in the amount of exempt foreign income by a certain percentage, say 5%? What effect would a territorial system have on the foreign tax credit system (because there would not be a foreign tax credit for foreign taxes attributable to exempt foreign income)? Furthermore, when considering a territorial system, it would be necessary to examine the sourcing rules and transfer pricing rules, because in a territorial system there would be tax exemption for active foreign earnings and not just tax deferral. Finally, it would be necessary to reexamine the scope of the subpart F regime that taxes passive foreign earnings and certain other low-tax foreign income. As commentators have observed, the details of a territorial system are critical, and depending on its design, it could raise substantial revenue or lose substantial revenue, both for individual corporations and with respect to the corporate community as a whole.
6. On October 26, 2011, House Ways and Means Committee Chairman Dave Camp (R-MI) released an international tax reform discussion draft, including legislative language, that would move the United States to a territorial tax system. The Ways and Means draft international tax reform plan is intended to be revenue neutral. The plan would also reduce the corporate tax rate to 25%, but does not set forth base broadeners that might be used to pay for reducing the corporate tax rate to that level. Some of the highlights of the proposals in the discussion draft include:
   a. A 95% deduction (and no foreign tax credit) with respect to the foreign-source portion of dividends received from controlled foreign corporations

(CFCs) by U.S. corporations that are 10% U.S. shareholders of the CFCs (with foreign branches treated as CFCs and with an election to treat 10/50 corporations as CFCs), resulting in an effective rate of 1.25% on inbound dividends;

b. No disallowance for U.S. deductions attributable to exempt foreign income, such as interest deductions (the 5% inclusion of foreign-source dividends is a proxy for expense disallowance);

c. A deduction of 95% of gain on disposition of stock in certain active CFCs (with no deduction for losses on such transactions);

d. Retention of the subpart F rules, with foreign tax credits allowable with respect to subpart F income of a U.S. shareholder;

e. Elimination of indirect foreign tax credits (§902), the foreign tax credit baskets (§904), the foreign tax splitter rules (§909), the subpart F rule about investments in U.S. property (§956), and the exclusion from income for previously taxed earnings and profits (§959);

f. Mandatory inclusion in income, under subpart F, of pre-effective date foreign earnings of CFCs and 10/50 corporations, whether distributed or not, subject to an 85% deduction (but no foreign tax credits for the 85% portion), resulting in an effective tax rate of 5.25% on the inclusion (before foreign tax credits on the 15% portion), with an election to spread the tax over eight years;

g. A provision to prevent base erosion through excessive borrowing by denying interest deductions for U.S. shareholders of CFCs where there is disproportionate borrowing in the United States; and

h. Three alternative provisions to address base erosion caused by shifting of intangible property and its related income: (i) Option A: the Obama Administration proposal to treat excess income from transfers of intangibles to low-tax affiliates as subpart F income, (ii) Option B: a proposal to treat low-taxed foreign income (not just from intangibles) as subpart F income except to the extent it is derived from the active conduct of an active trade or business in the home country of the CFC, and (iii) Option C: a proposal taxing foreign intangible income at a reduced rate, but also treating income derived by CFCs from intangibles as subpart F income.

7. Although Chairman Camp's international tax reform proposal has many gaps, including a lack of transition rules, it is a noteworthy step in the tax reform debate because it is a concrete plan for policymakers and taxpayers to analyze and debate.

8. On February 9, 2012, Senator Michael Enzi, a member of the Senate Finance Committee, introduced an international tax reform bill. Like the discussion draft released by Chairman Camp, the Enzi bill would move the United States to a territorial tax system by providing a 95% dividend deduction. Also like the Camp draft, the Enzi bill is intended to be revenue neutral. However, the Enzi bill is different from the Camp draft in some significant respects. For example, the Enzi bill assumes a 35% corporate tax rate. In addition, it has an elective provision for

treatment of pre-effective date foreign earnings. Some highlights of the Enzi bill include:

a. A 95% deduction (and no foreign tax credit) with respect to the post-effective date foreign source portion of dividends received from CFCs by U.S. corporations that are 10% shareholders of the CFCs (with an election to treat 10/50 companies as CFCs but not treating foreign branches as CFCs);

b. No disallowance for U.S. deductions attributable to exempt foreign income, such as interest deductions (the 5% inclusion of foreign-source dividends is a proxy for expense disallowance);

c. A deduction of 95% of the gain on disposition of stock in certain active CFCs to the extent the gain is treated as a dividend under §1248;

d. Retention of the subpart F rules, with foreign tax credits allowable with respect to subpart F income of a U.S. shareholder, permanent extension of the subpart F active financing and look-through rules, and repeal of the foreign base company sales and services income rules;

e. An elective inclusion in income of pre-effective date earnings, subject to a 70% deduction (and no foreign tax credit), with an election to spread the tax over eight years, and to the extent the elective inclusion is not made, subsequent distributions are deemed to come first from pre-effective date earnings and are taxed at the applicable corporate tax rate, subject to foreign tax credits;

f. Somewhat similar to part of Option C of the Camp base erosion proposals, a deduction equal to 50% of foreign intangible income derived by a domestic corporation from the active conduct of a trade or business within the United States with respect to the intangible property giving rise to the income;

g. Unlike the Camp draft, no proposal to deny interest deductions where there is disproportionate borrowing in the United States; and

h. Somewhat similar to Option B of the Camp base erosion proposals, treatment of low-taxed foreign income (not just from intangibles) as subpart F income, except to the extent it is qualified business income attributable to the active conduct of a trade or business (not including income from intangibles).

9. Although there are substantial differences between the approach in the President's Framework as compared to the Camp/Enzi proposals, nevertheless there appear to be some important similarities that could form the basis for agreement on business tax reform. The common themes are:

a. lowering the corporate tax rate;

b. broadening the base;

c. concerns about base erosion;

d. no consumption tax, such as a VAT; and

e. revenue neutrality.

10. Concerns about base erosion include issues that already exist under current law. For example, there are concerns about the movement of activities and income offshore, and the effectiveness of transfer pricing rules, in particular as they relate to income from intangibles. These issues are a central focus of the OECD BEPS project, previously discussed.
11. It is important to observe that revenue neutrality means that there would be winners and losers if business tax reform is enacted. This might split the business community as the tax reform process moves forward. It could exacerbate potential differences of views between, for example, corporations and pass-through entities, between multinational and domestic-only corporations, between inbound and outbound companies, between capital intensive and financial services companies, and between businesses favoring retention of particular incentives and those desiring the largest possible rate reduction.

## D. Chairman Camp's Other Tax Reform Proposals

1. On January 24, 2013, House Ways and Means Committee Chairman Dave Camp released a financial products tax reform discussion draft, including legislative language. The Overview that accompanies the discussion draft states that "this discussion draft will be considered as part of comprehensive tax reform legislation that broadens the base, lowers rates, and moves the United States to a more economically competitive tax system on a revenue-neutral basis." Some of the highlights of the proposals in the discussion draft include:
   a. A provision requiring that all derivatives, broadly defined (but not including hedges and certain real estate transactions), must be marked to market, with gains and losses treated as ordinary income or loss;
   b. A provision permitting taxpayers to rely upon, for tax purposes, an identification of a transaction as a hedge that they have made for financial statement purposes, provided the transaction also satisfies the definition of a tax hedging transaction;
   c. A provision eliminating phantom income to a borrower whose debt has been restructured;
   d. A provision requiring market discount to be taken into account currently similar to original issue discount, but limiting market discount to the amount that reflects increases in interest rates since the loan was originally made and not deterioration in the creditworthiness of the borrower;
   e. A provision requiring a taxpayer who sells a portion of his stock or securities in a particular company to use the average basis of the stock orsecurities for purposes of computing gain or loss on the disposition; and
   f. A provision expanding the scope of the wash sale rules (which deny losses on the disposition of securities where the taxpayer buys the same or substantially similar securities soon after selling the loss securities).
2. On March 12, 2013, House Ways and Means Committee Chairman Dave Camp released a small business tax reform discussion draft, including legislative lan-

guage. The discussion draft would reform and simplify various tax rules affecting small businesses. In addition, the discussion draft offers two approaches to reform the tax treatment of S corporations and partnerships. Some of the highlights of the proposals in the discussion draft include:

a. Providing permanent §179 expensing for new equipment and property up to $250,000, with the deduction phased out for investments exceeding $800.000 (both amounts indexed for inflation);

b. Permitting all businesses with gross receipts of $10 million or less to use the cash method of accounting;

c. Establishing a single provision applicable to all businesses for start-up and organizational expenditures;

d. Changing the due dates for business tax returns;

e. Making various changes to the rules relating to the taxation of S corporations and partnerships; and

f. Proposing a new unified pass-through regime for non-publicly traded businesses that would replace the current rules for taxing S corporations and partnerships.

## E. Concluding Points

1. Despite certain common themes, it is clear that the tax reform debate still has a long way to go. There is a fundamental disagreement between Democrats and Republicans as to whether tax reform should increase federal revenues. Democrats insist that tax reform must help reduce the federal deficit, but Republicans insist that tax reform must be revenue neutral and the federal deficit must be reduced by spending cuts.
2. The debate about individual tax reform has not yet begun. In addition, serious debate about how to lower the corporate tax rate has not yet occurred. Policymakers are realizing that business tax reform cannot be limited to corporate taxation, and they are starting to focus on the treatment of owners of pass-through entities and sole proprietorships.
3. Businesses and individuals should pay attention to the tax reform debate. For example, corporations should monitor the debate, and should consider the potential effect of various reform alternatives. Would lowering the rate and broadening the base help a particular corporation, or would the loss of tax preferences put the corporation in a worse position? Would a particular corporation prefer territorial taxation and, if so, what are the details of a favorable territorial system for that corporation?
4. Taxpayers should decide what role they would like to play in the tax reform debate. Do they prefer only to monitor the debate? Or do they want to educate policymakers about the options and about the consequences of the options? For example, business taxpayers might want to educate policymakers about their industries and the potential effect of reform options.

5. Because tax reform is so complicated from a political and technical standpoint, it will require a lengthy process to consider and enact. The last major overhaul of the Internal Revenue Code, in 1986, was difficult to achieve and took a few years from inception to enactment. As indicated above, the Obama Administration has expressed support for fundamental tax reform. To date, however, the Obama Administration has put forward only a framework for business tax reform and not a specific proposal for fundamental overall reform, although it has indicated that it favors lowering the corporate tax rate and broadening the business tax base, on a revenue neutral basis, and it continues to favor increasing taxes for upper-income taxpayers.
6. In August 2012, the House of Representatives passed a bill to provide an expedited process for consideration of tax reform legislation in 2013. To qualify for the expedited process, the bill would be required to (1) consolidate individual income tax brackets to not more than two brackets of 10% and not more than 25%; (2) reduce the corporate tax rate to not greater than 25%; (3) repeal the AMT; (4) broaden the tax base to maintain federal revenue between 18% and 19% of the economy; and (5) change to a territorial tax system. The White House announced that President Obama would veto the House bill, and the bill did not advance.
7. Tax reform will require leadership by the President. It will also require cooperation between Democrats and Republicans, and cooperation between the House and Senate, both of which are lacking at the present time. President Reagan took the lead in the 1986 tax reform and there was cooperation in Congress.
8. Many experts believe that the income tax and payroll taxes alone cannot supply sufficient revenue to fund the needs of the federal government. Consequently, someday the United States might have to consider an alternative source of revenue, such as a VAT or a carbon tax.
9. Regardless of whether and when federal tax reform moves forward, federal, state and local governments, as well as foreign governments, are under great pressure to raise revenues. They will do so by more enforcement and perhaps by additional legislation. In order to reduce opposition to raising taxes, legislatures will raise revenues by enacting provisions that are labeled as "loophole closers". Various revenue raisers described as loophole closers include the international tax provisions (e.g., foreign tax credit provisions to prevent splitting foreign income from foreign taxes and to address acquisitions that provide a step-up in asset basis for U.S. tax purposes but not for foreign tax purposes) that were enacted in 2010 in the Education Jobs and Medicaid Assistance Act (Public Law 111-226), and the carried interest provision that has been included in bills but not enacted. In addition, revenue raisers may be used to pay for non-tax programs (e.g., the use of international tax provisions in the Education Jobs and Medicaid Assistance Act), rather than to pay for tax reductions or deficit reduction.
10. Finally, taxpayers and advisors should remain vigilant about revenue raisers that have been proposed but are not currently included in any current bill. For example, the Obama Administration budget proposal for FY 2014 includes various revenue raisers, particularly for upper-income individuals and businesses. Businesses should be particularly alert to the international tax proposals therein,

including the proposals that would defer deductions of interest expense related to deferred income, that would determine the foreign tax credit on a pooling basis, and that would tax excess returns associated with transfers of intangibles off-shore.

11. Taxpayers and their advisors need to pay attention to the debates about spending and tax reform. Although the debates still have a long way to go, citizens and their advisors need to monitor the debates and should evaluate the effects of potential reform alternatives. They also need to decide what role they want to play in the tax reform debate. If a taxpayer decides to take an active role in the tax reform debate, including educating or otherwise interacting with policymakers, it is better to participate now rather than waiting until the debate is far along when it might no longer be possible to influence the outcome.