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Tax Planning in this Uncertain Environment

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TAX PLANNING IN THIS UNCERTAIN ENVIRONMENT

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I. INTRODUCTION

A. The current environment

1. These are challenging times. Continuing change is a certainty, particularly in the area of taxation. This statement applies not only to federal taxation, but also to state and local taxation and taxation of overseas activities.

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. Of course, 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 recent financial crisis resulted in more government spending and less tax revenues. The budget deficit for the United States for the fiscal year ending September 30, 2009 was $1.4 trillion. The federal budget deficit for the fiscal year ending September 30, 2010 is expected to be about the same as the deficit for the previous year. Substantial federal deficits are expected for many years to come. The Obama Administration and Congress are very concerned about the budget deficit, and it is an important factor in their deliberations about spending and taxes. Many states, such as California, and local governments are having similar financial difficulties.

3. 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. Most recently, the IRS has proposed a schedule to require certain businesses to disclose uncertain tax positions. The schedule would require taxpayers to provide the primary Internal Revenue Code sections relating to an uncertain tax position, set forth the maximum potential tax adjustment and provide a concise description of the position. It is anticipated that this schedule will become effective for returns filed for 2010. The IRS has stated that its goals for this program are certainty, consistency and efficiency. The IRS faces the challenge of modifying its processes to achieve these goals. Business taxpayers should be focusing now on this new disclosure requirement.
by identifying their uncertain tax positions and considering how they will describe them on the schedule, particularly the concise description of the position.

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 more than $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. The IRS has estimated the tax gap at more than $300 billion per year, or about 15% 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. The IRS announced that there were approximately 15,000 applicants to the program. In addition, the Swiss parliament has voted to permit the transfer of information to the IRS about 4,450 secret accounts at the Swiss bank UBS.

4. Tax authorities are increasingly taking the position that business taxpayers have sufficient nexus to be taxable in the jurisdiction. For example, state tax authorities are increasingly assertive in this regard.

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. Most recently, Congress has codified the economic substance doctrine, and has 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. 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.

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 currently is seeking a corporate taxpayer to volunteer to participate in a joint audit by the IRS and another country’s revenue authority.

3. Multilateral cooperation about tax issues will increase.

a. For example, the Organisation for Economic Cooperation and Development (OECD) is a group of about 30 countries that provides a forum where governments compare and exchange policy views, identify good 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 commissioners from countries around the world to share ideas on how to improve tax administration. IRS Commissioner Douglas Shulman is the current chair of the FTA. 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. 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

1. 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 to attract 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. At the G-20 summit in Toronto in June, it became apparent that national interests are starting to strain the level of global cooperation that existed at the early stages of the financial crisis.

F. Timing of stimulus wind-down

1. Governments initiated many economic stimulus programs to address the recent financial crisis. The programs included tax incentives. Governments need to determine when and how to wind down government economic stimulus programs while avoiding potential negative economic effects of withdrawing the stimulus. Many economic stimulus programs are temporary. Lawmakers need to decide whether the programs are still necessary, and must decide whether to renew the programs. An example of the difficulty of this issue is the federal homebuyer credit. Home sales dropped dramatically after the credit lapsed at the end of April. Lawmakers may be reluctant to end programs once established, but renewing the programs adds to budget deficits. At the G-20 summit in Toronto in June, global economic leaders sought to balance the need for fiscal austerity with calls for measures to encourage growth to sustain the economic recovery.

G. Legislative consideration of tax increases

1. Because of budgetary pressures, governments need to cut spending, raise taxes, or both. Cutting spending is very difficult. In fact, 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, putting greater pressure on reducing spending for discretionary programs.

a. In February of this year, President Obama signed an executive order creating a bipartisan National Commission on Fiscal Responsibility and Reform. The mission of the Commission is 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 directs 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 is directed to propose recommendations that meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending. The Commission is directed to vote on the approval of a final report no later than December 1. It is possible that the recommendations will include tax increases as well as spending reductions.

b. In addition, on August 27 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 value-added tax (VAT) in addition to or in lieu of the current income tax system.

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 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 supports raising taxes on Americans with more income and on various sectors of business activity.

b. 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 this year 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, 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 HAZY FEDERAL LEGISLATIVE OUTLOOK FOR THE REST OF 2010

A. Estate tax

1. For decedents in 2009, the top estate tax rate was 45% and the exemption amount was $3.5 million. Contrary to expectations, Congress permitted the estate tax to expire for 2010 as scheduled under the Economic Growth and Tax Relief Reconciliation Act of 2001.

2. Will Congress reinstate the estate tax for 2010? As time passes, it becomes harder for Congress to do so.

3. For 2011, the estate tax is scheduled to return with a top rate of 55% and an exemption amount of $1 million. Will Congress amend the estate tax for 2011 and thereafter?

4. The Obama Administration budget proposal for FY 2011 (submitted to Congress on February 1 of this year) assumes that estate and gift taxes will be permanently extended at parameters in effect for 2009, i.e., a top rate of 45% and an exemption amount of $3.5 million. The Administration assumption about estate tax would lose revenue as compared to current law. The revenue tables in the FY 2011 Budget indicate that enactment of this assumption would result in a revenue cost of $262 billion over ten years as compared to current law.

5. Early this year Congress approved, and the President signed, a paygo resolution to require offsets for tax relief, but the paygo resolution has a two-year exemption for the cost of extending the estate tax at the 2009 parameters.

6. There have been discussions in Congress about what to do about estate tax for 2011 and thereafter, but no agreement has been reached. As time passes, it becomes increasingly possible that Congress will not enact legislation to modify the estate tax for 2011 (or thereafter).
7. In view of the substantial uncertainty surrounding estate tax, individuals should consult their advisors to determine what, if anything, they should consider doing in 2010 regarding estate planning. At a minimum, individuals should review their current estate plans to ensure the plans continue to accomplish the desired goals. In addition, individuals should review their state estate tax plan.

B. Extenders

1. Approximately 50 provisions expired at the end of 2009, including, for example, 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 is struggling to enact legislation to extend them for one year – 2010. Even if Congress enacts extenders for 2010, Congress will need to revisit extenders for 2011 and thereafter.

2. Under its paygo resolution, Congress intends to pay for the one-year extensions. However, there is opposition to some of the revenue raisers, making it difficult for Congress to enact the legislation. The legislation would pay for the extenders with permanent changes to the tax law, including a substantial change to the treatment of carried interests.

3. Congress would pay for extenders by changing the tax treatment of “carried interests”, which are partnership interests sharing in future profits that are received in exchange for services. Under normal partnership rules, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, reflect their shares of such gain on their tax returns as long-term capital gain. The legislation would change the treatment of certain carried interests, treating a partner’s income as ordinary income rather than capital gain. For individuals, a specified portion of the income would be treated as ordinary income, rather than the entire amount.

a. In general, proposed § 710 of the Code would treat net income from an “investment services partnership interest” (an “ISPI”) as ordinary income except to the extent it is attributable to the partner’s “qualified capital interest” (i.e., certain invested capital). Thus, the provision would recharacterize the partner’s distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income in the hands
of the partner. Such income would be taxed at ordinary income rates and would be subject to self-employment tax.

b. Proposed § 710 would treat net loss from an ISPI as ordinary loss, but would allow the loss only to the extent the aggregate net income from the ISPI for prior partnership years exceeds aggregate net losses allowed for prior partnership years to which the provision applies. Net loss that is deferred would be carried forward to subsequent years.

c. An ISPI is a partnership interest held by any person if it was reasonably expected, at the time the person acquired the partnership interest, that the person or any related person would provide, or already has provided, a substantial quantity of certain services with respect to “specified assets” held by the partnership. The services are (1) advising as to the advisability of investing in, purchasing, or selling any specified asset, (2) managing, acquiring, or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets, and (4) any activity in support of the foregoing services.

d. “Specified assets” means securities, real estate held for rental or investment, partnership interests, commodities, or options or derivative contracts with respect to such securities, real estate, partnership interests, or commodities.

e. Thus, the provision has broad applicability to many kinds of partnerships and LLCs taxed as partnerships, not just hedge funds and private equity funds. For example, it can apply to interests in partnerships or LLCs with real estate held for rental or investment. In addition, it can apply to interests in partnerships or LLCs that invest in other partnerships or LLCs, even if the lower-tier partnership conducts an operating business.

f. Furthermore, the provision would apply to the disposition of an ISPI. On the disposition of an ISPI, gain (other than gain attributable to the partner's qualified capital interest) would be treated as ordinary income, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest generally is considered as capital gain or loss. Except in certain narrow situations, income on the disposition of an ISPI would be recognized notwithstanding any other income tax provision, including nonrecognition provisions that would otherwise
apply. Net loss from the disposition of an ISPI would be treated as ordinary loss, but only to the extent of the amount by which aggregate net income previously treated as ordinary income under the provision exceeds aggregate net loss previously allowed as ordinary loss under the provision.

**g. The disposition rule would recharacterize all the gain from disposition of an ISPI (other than gain attributable to the partner’s qualified capital interest), even the portion of the gain attributable to assets that are not specified assets.**

**h. In general, § 710 is proposed to be effective for taxable years starting in 2011. Although the extenders legislation including the carried interest provision has not yet been enacted, there is a significant likelihood that extenders will be enacted at some point this year. This means that taxpayers have until the end of this year to consider their options and arrange their affairs to lessen the impact of the legislation. Even if somehow extenders are not enacted this year, it is likely that carried interest legislation will be enacted at some point in the future to pay for something.**

**i. There are some steps taxpayers might consider taking to mitigate the impact of § 710. Taxpayers and their advisors should be considering possible actions, but should be careful to understand the business and tax issues raised by these possibilities, as taking certain actions to deal with § 710 could raise other business or tax issues.**

**j. For example, before 2011, a partnership or LLC in which someone owns an ISPI might consider distributing non-specified assets out of the partnership or LLC, so that income from the non-specified assets is not recharacterized and there is less future gain on disposition of the ISPI to be recharacterized. Similarly, taxpayers might consider dividing a partnership or LLC into two partnerships or LLCs, one with specified assets and one without specified assets. As indicated above, care must be taken to ensure that any actions do not cause other business or tax issues. For example, whereas often the distribution of property by a partnership or LLC is nontaxable, there are provisions in §§ 704, 707, 731 or 737 that could render distributions taxable.**

**k. In a situation where a partnership’s specified asset is an interest in another partnership, taxpayers might consider trying to combine the two**
partnerships. For example, if a partnership owns an interest in a lower-tier partnership that conducts an active business, one might consider combining the partnerships so that there is no longer a specified asset in the form of a lower-tier partnership interest. Alternatively, one might consider trying to convert the lower-tier partnership into a disregarded entity for tax purposes.

I. As indicated above, an ISPI is a partnership interest held by any person if it was reasonably expected, at the time the person acquired the partnership interest, that the person or any related person would provide, or already has provided, a substantial quantity of certain services with respect to specified assets. Upon forming a new partnership or LLC, one might consider contracting with an unrelated person to provide the necessary services.

C. Alternative minimum tax (AMT)

1. Unlike the brackets for regular income tax, the exemption amount for the AMT is not indexed for inflation. Consequently, if the exemption amount is not adjusted, more and more taxpayers will become subject to the AMT.

2. Because state and local taxes and personal exemptions are not deductible for AMT purposes, more and more middle income taxpayers are at risk of becoming subject to the AMT.

3. Each year, Congress temporarily raises the exemption amount and allows the use of certain personal credits against AMT liability, together the so-called “AMT patch”.

4. Congress enacted an AMT patch for 2009 in the American Recovery and Reinvestment Act of 2009, keeping the number of AMT taxpayers at about 4 million. If a patch is not enacted for 2010, the number of AMT taxpayers will be about 27 million.

5. The revenue cost of enacting an AMT patch for 2010 would be over $60 billion.

6. The paygo resolution approved by Congress and signed by the President early this year includes a two-year exemption for the cost of an AMT patch.
7. It is likely that an AMT patch will be enacted for 2010, in particular because of the impact on middle income taxpayers if a patch is not enacted.

8. The Obama Administration budget proposal for FY 2011 reflects permanent extension of the AMT patch with annual indexation of the AMT exemption amount. The revenue tables in the FY'2011 Budget indicate that this would result in a revenue cost of $659 billion over 10 years.

D. Expiration of the 2001/2003 tax relief

1. The 2001 and 2003 tax relief is scheduled to expire at the end of this year.

2. Unless Congress acts, the following will occur:
   a. The two highest marginal income tax rates will rise to 36% and 39.6% from 33% and 35%, respectively.
   b. The 10% tax bracket will be eliminated.
   c. The maximum tax rate on qualified dividends will rise from 15% to 39.6%.
   d. The maximum tax rate on long-term capital gains will rise from 15% to 20%.
   e. Phase-outs of itemized deductions and personal exemptions will be reinstated for high-income individuals.
   f. Marriage penalty relief will expire.
   g. The amount of the child tax credit will decline from $1,000 to $500.

3. Also note that, under the recently enacted health care reform legislation, beginning in 2013 individuals will be 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 will be 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.
4. The Obama Administration has indicated its support to extend the 2001/2003 tax relief for low-income and middle-income individuals, but not for those individuals with income over $250,000 for joint returns and $200,000 for single individuals. The Obama Administration budget proposal for FY2011 does, however, propose to cap the maximum tax rate on dividends at 20% for high-income individuals.

5. The paygo resolution approved by Congress and signed by the President has an exemption for the cost of permanently extending the tax relief for low-income and middle-income individuals. Even if in the near future Congress extends the tax relief for low-income and middle-income individuals, because of the large amount of revenue involved and the impact on the budget deficit, it is not likely that Congress would extend that relief for more than one or two years.

6. Regardless of whether Congress acts this year regarding the expiration of the 2001/2003 tax relief, tax rates are likely to climb in 2011 and later years, particularly for high-income individuals. Individuals and businesses should be analyzing their circumstances to determine the best course of action in anticipation of the changes.

7. The legislative situation is dynamic and hard to predict, so taxpayers and their advisors need to monitor legislative events carefully. Taxpayers and their advisors need to be flexible. Individuals and businesses should be considering their options now, so that, if necessary, they can take action before the end of 2010.

8. Planning considerations for high-income individuals.

    a. If Congress fails to act, the expiration of the 2001/2003 tax relief will have a substantial impact on individuals in all income ranges. If Congress extends the tax relief only for low-income and middle-income individuals, then the impact will be on high-income individuals. Because there is a good chance that Congress will extend the 2001/2003 tax relief for low-income and middle-income individuals, at least on a short-term basis, the following discussion will focus on high-income individuals.

    b. In 2011, high-income individuals face an increase in the top income tax marginal rates, a higher tax rate on dividends and capital gains, phase-outs of itemized deductions and personal exemptions and, in 2013, a
higher Medicare tax rate on wages and a Medicare tax on net investment income.

c. As noted below, high-income individuals might consider accelerating certain income into 2010, but of course remember that although the tax rate may be lower in 2010, tax will be due sooner and the individual will need to have the cash to pay the accelerated tax.

d. The magnitude of the effect of the anticipated 2011 changes will depend largely on the level and composition of the taxpayer's income, and on whether the taxpayer is subject to the AMT. Note that under current law individuals receive the benefit of the lower tax rates on dividends and capital gains for AMT purposes too, so the increase in rates on dividends and capital gains will have an AMT impact as well. For high-income individuals, the AMT impact of the increase in rates on dividends and capital gains could be more significant than the increase in the top marginal rates for other income. **Individuals need to take into account potential AMT effects in analyzing the effect of the 2011 changes and in making planning decisions.**

e. To the extent a high-income individual has the power to affect the timing of dividends, he or she would prefer to receive dividends in 2010, taxable at a 15% rate, rather than in 2011 or thereafter, potentially taxable at a maximum rate of 39.6% (plus the 3.8% Medicare tax on net investment income starting in 2013).

f. High-income individuals might consider accelerating capital gains into 2010 so they are taxed at a 15% rate rather than at a 20% rate (plus the 3.8% Medicare tax on net investment income starting in 2013).

g. High-income individuals might consider postponing the recognition of capital losses until 2011 or thereafter to offset future gains that would be taxed at a higher rate. Note that the $3,000 annual limitation on the use of capital losses against ordinary income continues to apply, so deferring capital losses is generally helpful only if there are future capital gains to offset.

h. High-income individuals might consider rebalancing their investment portfolio to receive more capital gains, taxable at a 20% rate, rather than dividends, taxable at a 39.6% rate.
i. High-income individuals might consider rebalancing their investment portfolio to include more tax-exempt investments, although the benefit of the tax exemption might be offset by lower returns. In addition, investments that are tax-exempt at the federal level might still be subject to state tax.

j. High-income individuals might consider deferring itemized deductions, such as state and local taxes and charitable contributions, into 2011 or thereafter to use the deductions to offset income subject to higher tax rates. However, note that in 2011 the phase-out of itemized deductions is scheduled to be reinstated for high-income individuals. Also note that the AMT denies the use of various itemized deductions, such as state and local taxes, so postponing itemized deductions might eliminate their value for an individual subject to AMT. Finally, note that the Obama Administration budget proposal for FY 2011 includes a legislative proposal to cap the tax rate at which itemized deductions reduce tax liability to 28%. Although this proposal does not appear to have received much support in Congress, if it were enacted it would motivate taxpayers to consider accelerating itemized deductions into years prior to its effective date.

k. Because of the anticipated increase in the top marginal rates, executives might consider exercising nonqualified stock options in 2010 rather than later. The early exercise of options would trigger ordinary income at lower rates, and allow the executive to receive capital gain on future appreciation in the stock. However, by exercising early, the executive gives up an important advantage of holding an option, which is the ability to limit downside risk while enjoying upside potential in the stock.

l. Similarly, executives receiving restricted stock in 2010 should consider whether the anticipated increase in the top marginal rates makes it advantageous to make a § 83(b) election to recognize the value of the restricted stock in 2010 rather than later when the stock vests. Under the general rules of § 83, stock received by an employee for services but subject to a substantial risk of forfeiture to the employer is not taxed upon receipt, but there is compensation income at the time the stock becomes substantially vested in the amount of the stock value at the time of vesting. If the employee makes a § 83(b) election, which must be made within 30
days after the stock is received, the value of the stock is compensation income on the date of receipt, there is no recognition when the stock vests, and any future income results in capital gain. However, there may be disadvantages to making a § 83(b) election. If the value of the stock goes down, an executive will have reported more income than would have been reported upon vesting. In addition, if the stock is forfeited, the executive is not permitted to claim a deduction for the amount previously included in income.

m. Executives might reconsider their deferred compensation elections, as deferred compensation might seem less attractive in the future. Furthermore, executives might give some thought to requesting the acceleration of payment of deferred compensation, but they should remember that accelerating the payment of deferred compensation may be subject to the rules of § 409A, which puts limitations on nonqualified deferred compensation plans. Violation of § 409A can result in acceleration of tax on all of an individual’s deferred compensation, plus a 20% additional tax plus an interest charge.

n. Investors with traditional tax-deferred IRAs might consider the possibility of converting to a Roth IRA and electing to pay the tax on the conversion in 2010 at the lower marginal rates.


a. The anticipated 2011 tax changes will affect shareholders, executives and employees. Consequently, there are corporate tax planning considerations regarding a corporation’s dividend policy and executive compensation.

b. Public corporations might reconsider dividend policies. A public corporation might consider accelerating or raising the amount of dividends in 2010, which are taxable at a maximum rate of 15%. A public corporation might consider decreasing the amount of dividends in 2011 and thereafter, which will be taxable at a maximum rate of 39.6% (plus the 3.8% Medicare tax starting in 2013). Higher shareholder taxes on dividends will encourage corporations to retain more earnings.

c. After 2010, a public corporation might consider a stock buy-back program rather than dividends. In a stock buy-back program the
corporation redeems its shares from shareholders. Properly structured, this kind of program can be accomplished in a manner that results in capital gain treatment for the redeeming shareholders that will be taxable at a maximum rate of 20%, with basis offset, rather than at the 39.6% maximum rate for dividends.

d. C corporation earnings are subject to double tax, once at the corporate level and a second time on shareholders receiving dividends. For this reason, there is an incentive for corporations to use debt financing, which gives rise to deductible interest payments, rather than equity financing, which gives rise to nondeductible dividends. If the maximum tax rate on dividends rises, this will encourage corporations to use more debt financing.

e. For closely held C corporations, stock buy-back programs will not result in capital gain if the shareholders desire to keep their relative shareholdings constant. Closely held C corporations with earnings and profits might consider accelerating dividends into 2010. If sufficient cash is not currently available, these corporations might consider paying 2010 dividends in the form of a note. If a note is distributed, it results in a dividend in the amount of the value of the note. Of course, if a shareholder receives a note, he or she will need cash to pay the tax, so the corporation might consider paying 2010 dividends partially with a note and partially in cash.

f. Similar to public corporations, closely held C corporations might pay less dividends after 2010 and might use more debt financing rather than equity financing.

g. S corporations with earnings and profits accumulated in prior years as a C corporation might want to consider making a 2010 distribution and electing to treat it as coming out of C corporation earnings and profits under §1368(e)(3) rather than out of the accumulated adjustments account (i.e., the account reflecting S corporation income previously taxed at the shareholder level).

h. Business entities may wish to consider changes to executive compensation, such as accelerating the payment of bonuses and deferred compensation into 2010. However, as mentioned previously, acceleration of deferred compensation may be subject to § 409A, which, if violated
with respect to an executive, can result in substantial detrimental tax consequences for the executive. In addition, in the current environment, there is substantial government and public scrutiny of executive compensation, which must be taken into account by corporate decision-makers in evaluating possible actions. Moreover, a publicly held corporation must consider § 162(m), which denies a deduction to the corporation for compensation to an employee in excess of $1 million (or a lower amount in certain cases, such as those corporations that received assistance in the Troubled Assets Relief Program (TARP) and health insurance providers).

i. The anticipated 2011 increase in federal tax rates will cause the top individual marginal rate (39.6%) to exceed the top corporate marginal rate (35%). This rate differential might encourage flow-through entities (partnerships, LLCs and S corporations) to consider converting to C corporations. However, converting to C corporation status has many downsides that would need to be considered. For example, C corporation earnings are subject to double taxation, i.e., a tax on earnings at the corporate level and a tax to the shareholders on the receipt of dividends. In addition, once appreciated assets are in C corporation solution, extracting them will result in gain recognition. Consequently, there are many factors to consider in the analysis of whether to convert to C corporation status, including, for example, the level and components of taxable income, expectations about distributions of earnings, and the owners’ eventual exit strategy.

10. As the discussion above about the anticipated 2011 changes makes clear, there are complicated issues and the planning opportunities have potential downsides that must be identified and taken into account. Consequently, as indicated previously, taxpayers and their advisors should be considering and analyzing the options now.

11. In summary, for the balance of 2010 it is uncertain what tax legislation Congress will enact. Anticipation of the Congressional elections in November affected legislative activity before the election. The election itself has changed the composition of the House and Senate, which will affect tax legislation in the lame-duck period in 2010 and in the new Congressional session commencing in 2011.
a. Because Congress might not be able to reach agreement about estate tax, Congress might not reinstate the estate tax for 2010 and might allow the estate tax to return in 2011 with a top rate of 55% and an exemption amount of $1 million.

b. In significant part because Congress cannot agree on how to pay for the extenders for 2010, they might not be enacted.

c. If the AMT is not patched for 2010, the number of AMT taxpayers will rise from 4 million to about 27 million, which will include middle income taxpayers. The paygo resolution includes a short-term exemption for an AMT patch. Consequently, it is likely that Congress will enact an AMT patch for 2010.

d. It is uncertain what Congress will do about the expiration of the 2001/2003 tax relief. The Obama Administration supports extending the 2001/2003 tax relief for low-income and middle-income individuals, and the paygo resolution has an exemption for the cost of permanently extending the tax relief for low-income and middle-income individuals. However, because of the large amount of revenue involved, it is not likely that Congress would extend the relief for more than one or two years for these income classes. The prognosis is even more uncertain for high-income individuals. It is likely that the 2001/2003 tax relief will expire for high-income individuals, unless some temporary extension, perhaps for certain provisions such as the maximum tax rate on dividends, can be included in a deal for low-income and middle-income individuals. However, under the paygo resolution, it would appear that the cost of any extension for high-income individuals would have to be offset by revenue raisers.

IV. THE MURKY FEDERAL LEGISLATIVE OUTLOOK FOR 2011 AND BEYOND

A. Congress is preoccupied with the items it needs to deal with in the short term, including estate tax, extenders, AMT and the expiration of the 2001/2003 tax relief.

B. Over the past several years there has been 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 reform legislation (H.R. 3970). This year Senators Wyden and Gregg introduced a reform bill (H.R. 3018).

C. As indicated previously, in February of this year, President Obama signed an executive order creating a bipartisan National Commission on Fiscal Responsibility and Reform. The Commission is directed to propose recommendations to improve the nation’s long-run fiscal outlook. The Commission is directed to vote on the approval of a final report no later than December 1. The report may address the state of our tax system, and could include proposals for tax reform. In addition, on August 27 the tax reform subcommittee of PERAB submitted a report of options to simplify the tax system, improve compliance, and reform the corporate tax system.

D. 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, took a couple of years from inception to enactment.

E. 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.

F. An intensive debate about tax reform has not yet begun. It is possible that there will be hearings and other Congressional activity about tax reform in 2011, but it is unlikely it can be completed in 2011. 2012 is a Presidential election year, which might reduce the chances of its enactment in 2012. The chances of tax reform, and its elements, may depend upon who is elected President in 2012.

G. It is possible that the worsening budgetary situation will impel Congress to act on tax reform. In the course of considering spending cuts and revenue increases, Congress might decide that the best way to address the revenue side is to reform the tax system. As indicated previously, 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.

H. At the present time, it is impossible to predict what a reformed federal tax system would look like. However, one thing is relatively certain – taxes are likely to increase in order to deal with the budget situation.
I. Regardless of whether and when federal tax reform moves forward, federal, state and local authorities are under great pressure to raise revenues. They will do so by legislation and more enforcement. In order to avoid the appearance of 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 that were included in the Education Jobs and Medicaid Assistance Act (Education/Medicaid Act), and the carried interest provision included in the extenders bill. In addition, revenue raisers may be used to pay for non-tax programs (e.g., the use of international tax provisions in the Education/Medicaid Act), rather than to pay for tax reductions or deficit reduction.

J. Finally, taxpayers and advisors should be 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 2011 includes various revenue raisers, particularly for high-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, determine the foreign tax credit on a pooling basis, and tax currently excess returns associated with transfers of intangibles offshore.

K. In summary, the federal legislative outlook beyond 2010 is very uncertain. Although it does not appear that federal tax reform will occur soon, federal, state and local governments badly need revenue. There will be consideration of tax increases at all levels of government. Taxpayers and their advisors need to stay focused on potential law changes. To the extent possible, they need to anticipate changes and take measures to mitigate the potential effects of those changes.