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Washington Notes
Tax Legislation Update

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- President Obama and Congressional Democrats have proposed a significant amount of new spending priorities for 2010.

- While many questions have been raised about the ability of the Administration and Congress to find funding for these new initiatives, it is clear that a reduction in current spending alone will not be enough to cover the new programs and therefore it will be necessary for the President and Congressional Democrats to rely heavily on increasing taxes.

- There has already been an overreliance this year on revenue raisers to pay for new or expanded programs such as healthcare and climate change reforms and such actions are very likely to continue well into the future, given the daunting fiscal challenges facing the government.

- As Congress has all but concluded final consideration of financial regulatory reform, tax-related legislation appears likely to be the next major priority.

Overview

The federal government's fiscal house is in disarray, and by all reasonable projections, the budget will continue to grow much faster than the economy over the long run. While there is no shortage of ideas to bring spending under control and tame the overbearing tax code, policymaker's have been slow to come together and reach an agreement on mechanisms to curb the problem. Many of these ideas, including balanced budget requirements and fundamentally rewriting the tax code, have been around a long time and are available for implementation, but to date, the Congress has taken little action.

The President and Congress will attempt to tackle these problems, but there seems to be little reason to hope for major structural reforms in the short run. The best they will be able to do, and this assumes Congress is willing to go along, is start to turn the massive fiscal ship around and that will certainly be slow going. The options appear very straightforward – significantly reduce spending or increase taxes to pay for new programs. Neither party has shown much of a penchant for controlling spending in any meaningful way, so that leads to the inevitable reliance on generating more tax revenue. There has already been an overreliance this year on "revenue raisers" (aka "pay-fors" and tax increases) to pay for new or expanded programs, such as healthcare (nearly $400 billion in raisers) and job creation initiatives (nearly $80 billion in new taxes), and such actions are very likely to continue well into the future given the daunting fiscal challenges facing the government.

Congress views legislative action to provide middle class income tax relief as well as retroactive extension of the estate tax as measures that must be completed this year. Congress is also keen to pass additional economic stimulus and job creation legislation in the areas of small business tax and green energy tax incentives this year, which will need to be paid for with new revenue raising provisions. Additionally, there is some concern that Congress may try to use the bank tax to finance other tax/jobs bills, despite the

Administration's initial proposed plan to use the funds for deficit reduction (TARP repayment), which could prove politically unpalatable, given the strong desire of Congressional Republicans to use bank fee funds, as instructed by the operative TARP statute, to reduce the federal debt incurred as a result of TARP.

Congress will be somewhat constrained in its efforts to implement costly, broad-scale policy initiatives because the Democratic majority has renewed its pledge to fiscal responsibility going forward. They adopted PAYGO (Pay-as-you-go) rules last year that require revenue offsets (or revenue increase offsets) for new spending programs. Given the pressure placed on them by adopting these budget rules, Congress will be compelled to continue to focus heavily on tax issues this year and likely for many more down the road.

This edition of Washington Notes provides a summary of noteworthy pending tax measures, a detailed analysis of each and prospects for their enactment. It should be noted that there are many more potential revenue raisers in existence and more yet to be created. In addition, Appendix A provides a summary of these provisions.

Business Taxes

Bank Fee - The Administration's proposed budget for FY2011 includes a provision to impose a fee on financial firms with over $50 billion in assets. The annual fee would equal 15 basis points on liabilities, less Tier 1 capital and insured deposits. The fee, designed to remunerate federal government losses under the Troubled Assets Relief Program (TARP), would become effective in July 2010 and is estimated to raise $90 billion over 10 years. Some form of financial fee is very likely to be enacted this year. The Senate Finance Committee has held a series of hearings to further investigate the concept behind the bank fee, as well as different ways such a fee could be structured, *e.g.* a fee based on liabilities, a fee using risk-weighted assets as the base, or using a surtax based on income. The House Ways and Means Committee is likely to hold hearings on a bank fee this summer.

Bonus Taxes - Several bills have been introduced in Congress that would impose a fee on bonuses paid out by financial firms. The legislation that has gained the most momentum in this space would apply a one-time 50% fee on bonuses in excess of $400,000 that were paid out in 2009 by companies that received federal emergency economic assistance. Although this provision failed when brought for a vote in the Senate as an amendment to the jobs bill, it was filed again (and subsequently withdrawn) as an amendment to financial regulatory reform, and was not considered during debate on the bill. Nonetheless, given the Administration's preference for a longer-term, 10-year bank fee as discussed above, it is less likely that a more limited provision relating to bonus tax will be enacted this year.

Securities Transaction Tax - There are legislative efforts on Capitol Hill to impose a new tax on securities transactions. Both the House and the Senate have bills that would tax securities transactions at 0.25%, and levy a 0.02% tax on futures, swaps, bonds, and CDS, with options being taxed at the rate applicable to the underlying asset. If applied globally, the potential revenue worldwide is estimated to raise $100-$300 billion annually. We do not believe this will become law.

LIFO Accounting - At present, businesses are permitted to utilize a last-in, first-out (LIFO) accounting valuation method to dispose of newer inventory first, reducing the loss of depreciating assets and qualifying assets sold for more than the value for which they were acquired as capital gains under the tax code. The Administration's proposed budget for FY2011 would repeal the LIFO tax deferral and require older assets to be disposed of before newer inventory. Capital losses could be claimed if the assets were sold for less than their value at the time of acquisition. The provision would be effective at the end of 2010. The Congressional Joint Committee on Taxation estimates that LIFO repeal would raise $75 billion over ten years. Given the detrimental effects that LIFO repeal would have on U.S. manufacturers, we do not believe that the provision will become law, but it is likely to surface during consideration of tax bills as a potential pay-for.

COLI Interest - Currently, there is no federal tax on earnings credited under a life insurance contract; death benefits received are excluded from the recipient's gross income. The Administration has proposed to repeal the current exemption for pro rata interest expense disallowance for corporate-owned life insurance (COLI) policies on contracts covering employees, officers, and directors, other than 20% owners that are contract beneficiaries. The COLI exemption repeal is estimated to raise $7.8 billion over 10 years. Despite ongoing controversy surrounding COLI contracts, this provision is a small revenue raiser, and is unlikely to be included in tax bills this year, although it could potentially remain in the budget proposal, depending on the budget bills that come out of Congress.

Earnings Stripping - Present law permits tax-deductible payments by non-American companies to be made to related parties in a foreign jurisdiction. The Administration's budget includes a proposal to require corporations to pay withholding rates to a related party as if the payment had been made directly to the parent foreign corporation, unless the parent company is in a tax treaty jurisdiction. The proposal would impose this rule any time a U.S. entity makes a deductible payment to a foreign entity that is part of the same foreign-controlled group of entities as the U.S. subsidiary. Estimates suggest this requirement would raise $3.6 billion over 10 years. This provision may be more likely for serious consideration in conjunction with fundamental tax policy reform, which may be ripe next year, as opposed to changing this now and using the funds as a minor pay-for.

Foreign Tax Limitations – The Administration's budget includes a proposal to prevent American multinational companies from "splitting" foreign tax credits from the related foreign income, which would raise $6.3 billion over 10 years. That proposal has already been offered by House and Senate Democratic tax-writers as an offset for tax legislation extending expired tax provisions for 2010. On the same extender legislation, the Congress has also proposed several other new limits on foreign tax credits and other multinational tax structures that the Congress has labeled as loopholes, though many companies say these are reasonable and broadly used tax planning structures. Together, these foreign tax proposals raise over $14 billion over 10 years. We believe several of these proposals, especially the "splitter" proposal, are likely to be enacted this year.

Personal Taxes

Ordinary Income - While Congress intends to take action to extend the current Bush tax cuts for individual tax filers with ordinary income of less than $200,000 ($250,000 for families) at rates of 10%, 25%, and 28%, the current ordinary income rates for filers above that threshold will sunset at the end of this year, and rates will rise to 36% and 39.6% for "high-income earners" (defined as individuals with AGI above $200,000 and families above $250,000). Allowing the rates for high-income earners to expire is expected to raise $600 billion over the next decade.

Additionally, high-income earners will be subject to a 0.9% increase in Medicare payroll taxes (from 1.45 to 2.35% of wages), which was enacted to fund changes mandated by the health care reform law.

The Administration has also proposed to reduce itemized deductions for high-income filers to 28% (from 33%) and reinstate the personal exemption phase out. Although these changes are estimated to raise $291 billion over ten years, we believe they are unlikely to be enacted this year.

Capital Gains and Dividends - Under current sunset provisions, all filers would be subject to a 20% capital gains tax rate in 2011, with dividend rates subject to the applicable ordinary income rate. Although the Administration has proposed extending the current rates for the lower three tax brackets, for those in the upper brackets, we believe that a more likely scenario is a blended rate for both capital gains and dividends in the neighborhood of 25-28%. These rate changes are estimated to raise $106 billion over ten years.

High-income earners will also be subject to a new 3.8% Medicare tax on unearned investment income—including capital gains, dividends, and interest payments—which will become effective in 2013, pursuant to the health care reform law. This new tax is estimated to raise $30 billion annually (and $210 billion from 2013 to 2019). Another concern raised by the new Medicare tax on high-income earners is that it is not presently indexed for inflation and runs the risk of becoming the next generation's AMT as inflation as cost of living indices rise.

Grantor-Retained Annuity Trusts - Current law provides that the remainder interest of a grantor-retained annuity trust (GRAT) is determined by the present value of the retained annuity during the GRAT term, as derived from the fair market value of the property contributed to the trust. Under the Administration's FY2011 budget proposal, however, a GRAT would be required to have a minimum term of 10 years, the remainder interest would be required to have a value greater than zero, and any decrease in annuity during the GRAT term would be prohibited. The provisions would be applicable to trusts created after enactment and are estimated to raise $4.5 billion over ten years.

Estate Taxes - Under 2009 law, the now-expired estate and gift tax rate was 45%, with $3.5 million exempted ($7 million for families). This year the estate tax rate is 0% with a carry-over basis. However, without Congressional action, the rate will jump to 55% (subject to a $1 million exemption threshold) in 2011. As Congress has provided that a two-year exemption of the 2009 rates is not subject to the statutory pay-as-you-go requirement, legislative action to extend the 2009 rates through 2011 is viewed as critical to complete this year. The House had passed a permanent extension of the 2009 rates last winter, prior to the House enactment of the pay-go rule.

Carried Interest - Carried interest is currently subject to the capital gains tax rate (15% at present). As other revenue raisers become eliminated through their use in other enacted laws, however, remaining sources of significant revenue are limited, and carried interest remains at the top of the list. Treatment of carried interest as ordinary income is estimated to raise revenue in excess of over $24 billion over the next ten years, and lawmakers that have continuously called for changes to carried interest tax treatment are gaining more traction in the present tax and spend political environment. The House has added carried interest as a pay-for to the tax extenders bill. The current proposal would subject carried interest to 50% capital gains and 50% ordinary income rates until 2013, whereupon the split would be 25%/75%. While the real estate, private equity, and venture capital industries are lobbying hard for a different compromise, we believe there is a real possibility of this measure becoming enacted this year. Additionally, under the tax extenders bill, the sale of an interest in an investment services partnership, including goodwill, would no longer be valued as capital gains, but rather would fall under the rates contained in the carried interest provision.

Alternative Minimum Tax - In operation since 1970, but not indexed for inflation, the alternative minimum tax imposes a rate of either 26% or 28%, mostly on middle income families. The economic stimulus law enacted by President Obama in 2009 included a two-year AMT patch, but absent additional temporary or long-term remedial measures, the AMT will be reinstated for tax year 2011. Extension of the AMT patch, however, is highly costly, with a price tag in the $100s of billions. Although AMT is unlikely to be a major consideration in this year's tax debate, it is likely to be a major player when Congress takes up fundamental tax policy reform in the next couple of years.

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Appendix A

Tax	Pre-Bush Tax Cuts	Current	Anticipated	Projected Revenue
Ordinary Income for Filers Under $200K ($250K Families)	15%, 28%, 31%	10%, 25%, 28%	10%, 25%, 28% (likely effective tax year 2011); legislative action required to prevent statutory increase to 15/28/31% rates	Budget impact disregarded for purpose of Pay-Go
Ordinary Income for Filers Over $200K ($250K Families)	36%, 39.6%	33%, 35%	36%, 39.6% (sunset of expiring Bush tax cuts, effective tax year 2011)	$600B over 10 years
Capital Gains for Filers Under $200K ($250K Families)	Short term cap gains at ordinary income rates; long term at 5% for lower two brackets, 15% for other brackets	Short term cap gains at ordinary income rates; long term at 0% for lower two brackets, 15% for other brackets; 2011: short term to higher ordinary rates, long term 15% for lowest bracket, 20% others	20% for long-term cap gains (by statutory sunset of Bush tax cut in 2011)	Dividends and cap gains estimated to raise $106B
Capital Gains for Filers Over $200K ($250K Families)	Short term cap gains at ordinary income rates; long term at 5% for lower two brackets, 15% for other brackets	Short term cap gains at ordinary income rates; long term at 0% for lower two brackets, 15% for other brackets; 2011: short term to higher ordinary rates, long term 15% for lowest bracket, 20% others; healthcare law imposes 3.8% additional tax	20% for long-term cap gains (by statutory sunset of Bush tax cut in 2011); blended cap gains and dividends tax rate, between 25-28% likely effective tax year 2011	Dividends and cap gains estimated to raise $106B
Dividends for Filers Under $200K ($250K Families)	Taxed at ordinary income rates	5% for lower two brackets; 15% all other brackets; eff. 2011: taxed at ord. income rates	Ordinary income rates in 2011	Dividends and cap gains estimated to raise $106B

Dividends for Filers Over $200K ($250K Families)	Taxed at ordinary income rates	15%; effective 2011: taxed at ordinary income rates; healthcare law imposes 3.8% additional tax	Blended cap gains and dividends tax rate, between 25-28% (likely effective tax year 2011)	Dividends and cap gains estimated to raise $106B
Unearned Income Medicare Tax for Filers Over $200K ($250K Families)	NA	NA	Effective 2013, impose 3.8% tax on investment income -- interest, dividends & cap gains.	$30B annually ($210B from 2013-2019)
Increased Medicare Tax for Filers Over $200K ($250K Families)	NA	NA	Effective 2013, increase Medicare payroll tax by 0.9% to 2.35% of wages	
GRATS	NA	Remainder interest of a grantor-retained annuity trust is determined by present value of the retained annuity during the GRAT term from the fair market value of the property contributed to the trust	FY11 Budget proposal: require a GRAT to have a minimum term of 10 years; require the remainder interest to have a value greater than zero; prohibit any decrease in annuity during the GRAT term; applicable to trusts created after enactment	$4.5B over 10 years
Reduced Itemized Deductions for Filers Over $200K ($250K Families)	NA	Itemized deductions not limited for taxpayers, regardless of adjusted gross income	FY11 Budget proposal: limit itemized deductions to 28% (from 33%); reinstate personal exemption phase-out; unlikely to be enacted	$291B over 10 years

Estate Tax	55%, $675,000 excluded (was scheduled to increase to $1M in 2006)	0% (income rate), set to jump to 55% and $1M threshold in 2011 [2009 rate was 45%, threshold to $3.5M for individuals, $7M for married couples under EGTRRA]	Two year extension of 2009 rate expected to be retroactively applied to 2010, and extended through 2011	NA
Alternative Minimum Tax (AMT)	In operation since 1970 (not indexed for inflation)	Rate of either 26% or 28%; 2 year AMT patch included in ARRA law	Absent additional temporary or long-term fix, tax year 2011 will reinstate AMT	Extension is highly costly ($100sB+)
Carried Interest	NA	15% capital gains rate	50% capital gains/50% ordinary income split until 2013, 25% capital gains/75% ordinary income until 2016, 100% ordinary income rate after 2016 (no carve outs)	$18 billion over 10 years