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Proposals May Signal Direction of Future Tax Reform

After several years of hearings and forums intended to develop broad-based support for comprehensive tax reform, on February 26, 2014, House Ways and Means Committee Chairman David Camp (R-Mich.) released a draft tax reform plan (the Discussion Draft) that would significantly alter the Internal Revenue Code.[1] While few observers expect the Discussion Draft to move forward this year, Chairman Camp's proposals should be taken seriously, particularly those that would raise revenue.

It has been nearly 30 years since Congress last enacted tax reform legislation, and over the last three decades tax rates have increased and the Code has become more complex through the enactment of myriad credits, deductions and other provisions. Chairman Camp should be commended for taking a leadership role in moving tax reform back into the public debate and releasing a draft for public consideration and comment. His detailed proposals provide a useful starting point for a revived discussion on tax reform.

While Chairman Camp's Discussion Draft provides an important first step in a potential tax reform effort, serious movement towards reform likely remains out of reach in the near term. In public remarks, administration officials have signaled a renewed commitment to pursuing corporate tax reform, and while the broad principles the administration supports are well known (such as reducing the corporate tax rate to 28 percent), few details have been provided in the administration's budget submissions. Separately, newly installed Senate Finance Committee Chairman Ron Wyden (D-Ore.) has made clear that his immediate priority is to pursue an extension of temporary provisions that expired last year.

Nonetheless, there are several reasons why the details contained in the Discussion Draft should be taken seriously. First, it is widely agreed that the corporate income tax rate in the United States is substantially higher than the rates imposed by nearly all of our major trading partners. Continued concerns regarding capital flight from the United States eventually may induce Congress to get serious about reform, at which point the Discussion Draft is likely to be a key starting point for reform legislation. Second, the Organisation for Economic Co-operation and Development's focused effort to address base erosion and profit shifting is likely to lead a number of countries to revisit how they tax international income. The international tax reform proposals included in the Discussion Draft bear similarities to those endorsed by the administration in its budget proposal, suggesting that common ground should not be too hard to find. Third, with the mid-term election just over six months away, there is a high probability that Congress will focus on extenders this spring and summer (although legislation may not be enacted until a lame duck session following the election), and fiscal constraints may prompt adoption of some of the revenue raisers from the Discussion Draft to pay for extender legislation and other narrow legislative priorities.

1 Chairman Camp released both statutory language and a technical explanation prepared by the Joint Committee on Taxation (the Technical Explanation). *See* "Discussion Draft," *available at* http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft__022614.pdf. *See also* "JCT Tax Reform Materials," *available at* http://waysandmeans.house.gov/newtaxsection/jct-tax-reform-materials.htm.

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Finally, students of tax history will recall that the 1986 reform effort did not happen overnight. The Tax Reform Act of 1986 was the product of proposals from various corners, including a plan announced in 1982 by then Rep. Dick Gephardt and then Sen. Bill Bradley, a separate plan announced in 1984 by then Rep. Jack Kemp and then Sen. Robert Kasten, a detailed proposal released by the Treasury Department in 1984, and a second proposal released by the Treasury Department in 1985. The 1986 legislation also was the product of a chairman of the House Ways and Means Committee and a president, from different parties, who worked together to build support for tax reform. Viewed against this historic backdrop, Chairman Camp's broad proposals may represent the first phase of a new reform effort in coming years.

Summarized below are some of the more notable provisions included in the draft addressing the following areas: (1) corporate tax, (2) tax accounting, (3) financial products, (4) partnerships, (5) international tax, (6) the excise tax on "systematically important financial institutions" and (7) worker classification.[2]

Corporate Tax

Corporate Rate Reduction and Repeal of Corporate Alternative Minimum Tax (AMT)

The Discussion Draft would reduce the corporate income tax rate to 25 percent and also eliminate the corporate AMT. The staff of the Joint Committee on Taxation (JCT) estimates that together these two changes would result in a $790 billion revenue reduction over the 10-year budget window. The Discussion Draft more than offsets this with a long list of base-broadening, preference-reducing and other corporate provisions that are estimated to increase tax revenues by $1.2 trillion[3] in aggregate over the 10-year budget window. Some of the more significant proposals are described throughout this summary.

Taxpayers with significant deferred tax assets, especially net operating losses (NOLs), may face negative financial accounting consequences from the corporate tax changes. NOLs generally are valued for financial accounting purposes based on current law and the tax rates that will be in effect when the NOLs are utilized. Thus, under current law, a taxpayer with a large federal income tax NOL carry-forward that is expected to be utilized within the 20-year statutory carry-over period usually would reflect on its financial statements a deferred tax asset for 35 percent of the NOL carry-forward. If the corporate rate reduction in the Discussion Draft is enacted, that taxpayer may need to write down the value of that deferred tax asset to reflect the future lower tax rate.

Limitations on NOL Carry-Backs and Carry-Overs by Corporations

Compounding the financial accounting impact of the corporate rate reduction, the Discussion Draft also would limit the amount of NOL that may be carried over or carried back to 90 percent of taxable income (a limitation similar to the limitation in the current law corporate AMT), effective for NOLs used in tax years beginning after December 31, 2014. That is, for regular tax purposes, corporations would be able to deduct NOLs in the carry-back or carry-over year only up to 90 percent of taxable income for the year. Also, most of the special rules (for example, rules applying to specified liability losses) under which certain NOLs may be carried back earlier than the standard two years would be

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2 For additional information, *see* "Chairman Camp's Proposals Place REITs in the Crosshairs," *available at* http://www.skadden.com/sites/default/files/publications/Chairman_Camps_Proposals_Place_REITs_%20in_the_Crosshairs.pdf. *See also* "Ways and Means Tax Reform Bill Proposes Fundamental Changes to Executive Compensation," *available at* http://www.skadden.com/sites/default/files/publications/Executive_Compensation_and_Benefits_Alert_Ways_and_Means_Reform_Bill_Proposes_Fundamental_Changes.pdf.

3 According to the estimated revenue effects of the Discussion Draft, prepared by the Joint Committee on Taxation, the net revenue effect of the business tax reform provisions would increase revenues by $562.4 billion over the 10-year budget window after taking into account the projected $680.3 million revenue loss from reducing the corporate tax rate to 25 percent.

repealed. (The Discussion Draft does not change the general rule under current law that NOLs are carried back two years and then carried forward 20 years.) This limitation increases the likelihood of extending the NOL utilization period, and for some taxpayers, this may increase the likelihood of an increased valuation reserve because income projections may not support utilization within the 20 year carry-over period.

The possibility of balance sheet changes to deferred tax assets may be critical for taxpayers in regulated industries with capital requirements and other industries where book value is a key business metric (*e.g.*, banks, insurers and other financial institutions). Other taxpayers also may be affected through volatility in their effective tax rate in the year of enactment, impact on debt covenant ratios, and other non-tax effects from balance sheet changes. Taxpayers with significant deferred tax assets should monitor this issue.

Tax Accounting

New cash method limitations. The Discussion Draft, like a proposal released by former Senate Finance Committee Chairman Max Baucus last November (the Baucus Proposal),[4] would prohibit use of the cash method of accounting for most taxpayers with average annual gross receipts in excess of $10 million. Proposed to be effective for tax years beginning after December 31, 2014, the new cash method rules would require many personal service corporations, S corporations and partnerships that currently are permitted to use the cash method regardless of their size to change to the accrual method. In contrast, certain taxpayers could benefit under the Discussion Draft. Currently, C corporations and partnerships with C corporation partners are prohibited from using the cash method if they have average gross receipts over $5 million; the Discussion Draft would increase the threshold to $10 million.

Repeal of LIFO and LCM inventory methods. Like the Baucus Proposal, the Discussion Draft would repeal use of the last-in-first-out (LIFO) and lower-of-cost-or-market (LCM) inventory methods. The repeals, which would be effective for tax years beginning after December 31, 2014, would impact taxpayers in many industries, including the retail and oil and gas industries where LIFO is particularly advantageous and widely used. Taxpayers that would be required to change from the LIFO or LCM method would have an income inclusion under Section 481(a), and for some taxpayers (particularly those that have been in business for many years), the income inclusion could be significant.

Favorable income adjustment and spread period rules. For both a change from the LIFO or LCM method and a change from the cash to accrual method that would be required under the two proposals described above, the Discussion Draft would soften the blow of the resulting income inclusion somewhat by allowing a graduated and back-loaded spread of the Section 481(a) adjustment over 4 tax years — 10, 15, 25, and 50 percent in years one through four, respectively. Current law requires that such adjustments be included in income ratably over four years (*i.e.*, 25 percent in each year). Further, the four-year spread period would not begin until the first tax year after December 31, 2018, unless the taxpayer elects to begin the period earlier.

Repeal of current expense deduction for R&D. The Discussion Draft would eliminate the current deduction allowed for research and development costs. Instead such costs would have to be capitalized and amortized over five years (if the research is conducted in the U.S.) and 15 years (if the research is conducted outside the U.S.). The new rules would be phased in starting with tax years beginning in 2015, with full implementation in 2021.

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4 *See* "Senate Finance Chair's Accounting-Related Reform Proposals Would Repeal Favorable Provisions," *available at* http://www.skadden.com/sites/default/files/publications/Senate_Finance_Chairs_Accounting_Related_Reform_Proposals_Would_Repeal_Favorable_Provisions.pdf.

Phase-out of the Section 199 deduction. The Discussion Draft would phase out the domestic manufacturing deduction starting with tax years beginning after December 31, 2014, with a full repeal for tax years beginning after December 31, 2016. However, the proposal preserves for individuals a tax benefit from earning qualified domestic manufacturing income (which is defined using language similar to that used for purposes of section 199) by subtracting such income from "modified adjusted gross income" for purposes of the 35 percent bracket and the phase-out of the 10 percent bracket.

No more deferral of gain on like-kind exchanges. Rules that currently allow taxpayers to defer gain on the exchange of "like-kind" property would be repealed under the Discussion Draft. Although the Baucus Proposal also would repeal the like-kind exchange rules, it would preserve, to some extent, the ability to defer gain on the exchange of like-kind property through a "mass asset" depreciation regime. The Discussion Draft would not do so. The repeal of the like-kind exchange gain deferral rules would significantly impact the real estate industry, whose members are among the heaviest users of these rules. As a practical matter, repeal of the like-kind exchange rules would negatively impact liquidity in the real estate market, as many real estate assets are leveraged with nonrecourse debt that exceeds tax basis. The tax consequences of selling such properties may be so steep that the property owners will hold in the absence of like-kind exchanges. Also adversely impacted would be the cottage industry of "qualified intermediaries" whose business is to facilitate like-kind exchanges. The repeal would apply generally to transfers after December 31, 2014, but certain transfers subject to a binding contract would be grandfathered.

Limiting the benefit of the installment method. The Discussion Draft would make the use of the installment method of accounting less attractive for many taxpayers. The proposal would repeal special rules under which property used or produced in a farming business (which includes timber cultivation) is not treated as a dealer disposition and is not subject to the statutory interest charge or the general rule requiring gain recognition if the installment note is pledged as security for a loan. A number of paper and timber companies have sold property in recent years on the installment method, in part because of these favorable rules. The amendments would be effective for sales occurring after 2014.

Slow-down of depreciation and amortization. The Modified Accelerated Cost Recovery System (MACRS) has long been recognized as permitting cost recovery of many assets at a faster pace than their economic useful lives. The Discussion Draft would repeal MACRS in favor of the Accelerated Depreciation System (ADS), under which cost recovery is more closely matched to the asset's class life. The Discussion Draft, like the Baucus Proposal, would impose a slower cost recovery system than MACRS. ADS, however, likely would be more familiar to most taxpayers than the Baucus Proposal's system, under which all tangible personal property would be depreciated in pools under a mass-asset type regime. The Discussion Draft would also redefine a number of the existing classes for certain assets, would establish a process for Treasury to establish other classes, and would set 12 years (rather than the current 7 years) as the default recovery period for otherwise unclassified assets. Taxpayers could elect to increase their depreciation deductions to take into account inflation, which could have the effect of accelerating some depreciation deductions. All depreciable real property (including residential real property) would have a 40-year recovery period. The recovery period for amortizable intangible assets would be extended from 15 years (under current law) to 20 years, and the exception in section 197 for mortgage servicing rights would be repealed, such that mortgage servicing rights would be considered section 197 intangibles. The new depreciation rules would apply to property placed in service after December 31, 2016, and the new amortization rules would apply to intangible assets acquired after December 31, 2014.

Limits on current deductions for advertising expenses. Like the Baucus Proposal, the Discussion Draft generally provides that taxpayers would be permitted to deduct only 50 percent of advertising costs; the remaining 50 percent would be required to be capitalized and amortized over 10 years.

Advertising costs would be defined rather broadly and would include, for example, employee compensation if the employee's services are primarily related to specified advertising activities. However, a number of specific exceptions to the definition of advertising costs also are provided. The proposal would be phased in starting with tax years beginning after December 31, 2014, with the rules fully applicable beginning in 2018.

Repeal or change of numerous industry-specific provisions allowing accelerated deductions. The Discussion Draft would repeal or change several provisions of the Code under which taxpayers in specific industries currently are permitted to deduct all or part of their costs for certain items, including:

- qualified refinery expenses (Section 179C) – effective in 2014;
- energy-efficient commercial buildings (Section 179D) – effective in 2014;
- advance mine safety equipment (Section 179E) – effective in 2014;
- farmer's fertilizer expenditures (Section 180) – effective in 2015;
- qualified film and TV production costs (Section 181) – effective in 2014; and
- reforestation expenditures (Section 194) – effective in 2015.

Limited deferral of advance payments of income. The Discussion Draft would codify certain current rules allowing taxpayers to defer, for no more than one year, recognition of income from certain advance payments, but only to the extent income recognition is deferred on the taxpayer's financial statements. Prepaid subscription income and prepaid dues of membership organizations would be subject to these rules rather than to special rules now in place for those types of advance payments. The rules would apply to tax years beginning after December 31, 2014.

Less favorable methods imposed on some homebuilders. The Discussion Draft would require home construction developers with average annual gross receipts over $10 million to use the percentage of completion method, rather than the more favorable completed contract method allowed under current law. Also, multi-unit housing developers would be required to use the percentage of completion method for 100 percent of a contract, rather than 70 percent as under current law. The rules would apply to contracts entered into after December 31, 2014.

Financial Products

With certain additions and technical changes, the Discussion Draft largely reflects the financial products proposals that Chairman Camp released in January 2013 (the 2013 FP Draft).[5] Like the 2013 FP Draft, the Discussion Draft would overhaul the taxation of derivative financial instruments by imposing a uniform mark-to-market regime with respect to a broadly defined class of "derivatives." It also would modify the tax treatment of more conventional financial instruments and transactions in a number of important respects. These proposals raise a number of administrative issues and practical considerations for many different types of taxpayers, from sophisticated financial institutions and investment funds to individual investors.

The following discussion highlights certain key differences between the financial products proposals in the Discussion Draft and those in the 2013 FP Draft.

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5 For our original summary and analysis of the 2013 FP Draft, *see* "House Ways and Means Committee's Tax Reform Proposals for Financial Products," *available at* http://www.skadden.com/sites/default/files/publications/House_Ways_and_Means_Committees_Tax_Reform_Proposals_for_Financial_Products.pdf.

Mark-to-Market Regime for "Derivatives"

Like the 2013 FP Draft, the Discussion Draft would require all taxpayers to report gains and losses from derivatives under an annual mark-to-market method. Each derivative held by a taxpayer would be treated as if it were sold for its fair market value on the last business day of the taxable year. Any resulting gain or loss would be treated as an ordinary gain or loss.

The Discussion Draft still contains a very broad definition of "derivative." In general, a derivative would include any contract the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a partnership or trust; (3) any evidence of indebtedness; (4) any real property; (5) any actively traded commodity; (6) any currency; (7) any "rate, price, amount, index, formula, or algorithm"; or (8) any other item as the Secretary of the Treasury may prescribe. A derivative would not include direct ownership of any of the enumerated categories of assets (*e.g.*, stocks and bonds). As in the 2013 FP Draft, the mark-to-market requirement would apply to privately held as well as publicly traded derivatives. It also would apply without regard to whether any trading activity or liquidity exists with respect to the property referenced by the derivative.

The Discussion Draft provides a number of important, although narrowly drafted, exceptions. A derivative would not include (1) a compensatory option without a readily ascertainable fair market value under Section 83(e)(3); (2) to the extent provided by the secretary of the Treasury, a securities lending, sale-repurchase (or "repo"), or similar financing transaction; (3) a physically settled contract with respect to a commodity used in the normal course of the taxpayer's business; (4) an insurance, annuity or endowment contract issued by a domestic or foreign insurance company; or (5) a contract with respect to stock issued by a member of the taxpayer's worldwide affiliated group (as defined in section 864(f)).[6]

A number of aspects of these exceptions are not entirely clear. The Technical Explanation offers virtually no insight as to which types of arrangements might be considered a "financing" transaction similar to a securities lending or repo transaction.[7] Many of the exceptions appear to be aimed, sensibly enough, at limiting the scope of the mark-to-market requirement to instruments that are financial (as opposed to commercial or personal) in nature. Nevertheless, because the exceptions apply to very specific types of instruments, the proposed mark-to-market rule potentially could reach a wide range of ordinary business transactions. For example, absent an express exclusion, the general definition of "derivative" would seem to include any stock purchase or merger agreement that does not have a simultaneous signing and closing. The definition also would include warrants issued to lenders in a typical private lending transaction. Although presumably unintended by the drafters, it is possible to read the definition as including contingent rights and obligations under a guarantee or pledge agreement.

Similar to the 2013 FP Draft, the Discussion Draft adopts a bifurcation approach with respect to any financial instrument that has an "embedded" derivative component. In general, such an instrument would be disaggregated into two separate instruments (a derivative and a non-derivative), with the derivative component (but not the non-derivative component) required to be marked to market on an annual basis. In a helpful scale back from the 2013 FP Draft, however, this bifurcation rule would *not* apply to a convertible debt instrument (or seemingly any other form of debt, including a contingent payment debt instrument).

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6 Like the 2013 FP Draft, the Discussion Draft also provides exceptions for the following: (1) a contract on real property entered into by a real estate dealer, (2) a contract with respect to a single tract of real property and (3) a hedging transaction under Section 1221(b)(2) or 988(d)(1).

7 According to the Technical Explanation, the types of financing transactions to be excluded by the Secretary of the Treasury should "reflect current market practice and be flexible enough to accommodate future developments in the market but not be so broad as to undermine the general rule."

The Discussion Draft largely follows the 2013 FP Draft regarding the treatment of a so-called "mixed" straddle consisting of both derivative and non-derivative positions. The mark-to-market requirement would apply to *all* positions (derivatives and non-derivatives) of a mixed straddle. As in the 2013 FP Draft, a taxpayer would recognize any built-in (pre-straddle) gain in a non-derivative position immediately upon entering into the straddle, whereas any built-in (pre-straddle) loss in a non-derivative position would be suspended until such position is actually sold or terminated by the taxpayer. Unlike the 2013 FP Draft, however, the Discussion Draft would not require immediate gain recognition in the case of (1) a nonconvertible debt instrument that provides for interest at a fixed or permitted variable rate or (2) a qualified covered call option on stock held by the taxpayer.

The principal difficulty raised by the proposed mark-to-market regime continues to be the problem of valuation. As noted above, the mark-to-market requirement would apply to a privately held derivative even if there is no trading market whatsoever for that instrument or the property referenced by it. The Discussion Draft provides that fair market value would not take into account "any premium or discount based on the proportion of the total available trading units which are held." The Technical Explanation also indicates that non-tax reports and statements would be considered "evidence" of fair market value,[8] although this is of cold comfort to the many investors who do not prepare financial reports. Beyond these limited statements, the only other guidance in the Technical Explanation is that "general tax principles" should be consulted to determine the fair market value of a derivative. If Chairman Camp's mark-to-market proposal is enacted in its current form, the fair market value standard promises to be a source of controversy between taxpayers and the IRS.

Market Discount Proposal

Like the 2013 FP Draft, the Discussion Draft would generally align the market discount rules with the original issue discount (OID) rules by requiring the holder of a market discount bond to include market discount in income currently on the basis of a constant-yield accrual method.[9] The Discussion Draft also would aim to limit the application of the market discount rules to an amount of market discount that reflects (very roughly) the increase in interest rates since the debt instrument's original issue date. It would seek to accomplish this result by providing a bright-line cap on the accrual rate for market discount.[10]

The Discussion Draft improves upon the 2013 FP Draft by correcting a significant technical deficiency in the market discount proposal. It provides that any loss from the sale or exchange of a market discount bond would be treated as ordinary loss (rather than capital loss) to the extent of any market discount previously included in income by the holder. This generally would prevent a holder from having a character mismatch to the extent of its prior ordinary income inclusions with respect to the debt instrument.

Debt Restructuring Proposal

Like the 2013 FP Draft, the Discussion Draft includes a proposal to alleviate the problem of "phantom" cancellation of indebtedness (COD) income in certain debt restructurings involving publicly

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8 According to the Technical Explanation, financial statements would be given weight in the following order: (1) statements filed with the SEC and prepared in accordance with U.S. generally accepted accounting principles (GAAP), (2) statements filed with other federal agencies (other than the IRS) and prepared in accordance with GAAP, (3) certified audited financial statements prepared in accordance with GAAP, (4) statements filed with agencies equivalent to the SEC and prepared in accordance with international financial reporting standards, and (5) statements provided to other regulatory and governmental bodies as provided by the Secretary of the Treasury.

9 Under current law, if a holder acquires a debt instrument for less than its stated redemption price at maturity (or its "revised issue price" if originally issued with OID), any gain recognized on its subsequent disposition or retirement is generally treated as interest (ordinary income rather than capital gain) to the extent of the debt instrument's accrued market discount. Unlike OID, accrued market discount is not includible in income currently by a holder absent an election to do so.

10 In general, the cap would be equal to the greater of (1) the debt instrument's yield to maturity plus five percentage points or (2) the applicable federal rate (determined at the time the holder acquires the debt instrument by reference to its remaining term) plus 10 percentage points.

traded debt. Under current law, if the terms of a debt instrument are modified significantly (as determined under Treasury Regulation Section 1.1001-3), an issuer generally recognizes COD income to the extent that the issue price of the modified (new) debt instrument is less than the adjusted issue price of the unmodified (old) debt instrument.[11] The Discussion Draft would prevent this by providing that, in the case of an actual or deemed debt-for-debt exchange, the issue price of the new debt instrument is the least of (1) the adjusted issue price of the old debt instrument, (2) the stated principal amount of the new debt instrument or (3) the imputed principal amount of the new debt instrument.

The Discussion Draft would improve significantly the 2013 FP Draft's original debt restructuring proposal by enacting a new nonrecognition regime for holders of debt instruments. In general, a debt restructuring would have no current tax consequences to a holder unless it also receives non-debt property (or "boot") in the transaction, in which case the holder would recognize gain (but not loss) to the extent of the value of the boot. In a marked change from current law, nonrecognition treatment would apply regardless of whether the transaction qualifies as a "recapitalization" under section 368(a)(1)(E). Accordingly, the nonrecognition rule would apply even if the new debt or old debt has a maturity of fewer than five years (or otherwise fails to qualify as a "security" under the corporate reorganization rules), and even if the issuer is not classified as a corporation for U.S. federal income tax purposes.

Other Notable Additions and Changes

The Discussion Draft contains a number of other additions and changes to the 2013 FP Draft, including the following:

- **Treatment of convertible debt instruments.** The Discussion Draft directs the secretary of the Treasury to issue regulations treating convertible debt instruments in a manner similar to contingent payment debt instruments. In the case of a convertible debt instrument issued for cash, this presumably means that OID would be accrued by reference to the yield of a comparable non-convertible debt instrument, a major change from the current rules.
- **Special hedging transaction rule for insurance companies.** An insurance company would be permitted to treat any debt instruments that it holds to manage risks related to its insurance business as hedging transactions under section 1221(b)(2).
- **Mandatory FIFO method for dispositions of specified securities.** Upon disposing of stocks, bonds and other specified securities, taxpayers would be required to determine the tax basis of such instruments on a FIFO basis, except where the average basis method is otherwise allowed (*e.g.*, in the case of stock of a regulated investment company or stock acquired pursuant to a dividend reinvestment plan).[12] As under current law, tax basis would be reported on an account-by-account basis.
- **Application of Section 1032 to derivatives.** The nonrecognition rule of Section 1032 would apply to any derivative or other position entered into by a corporation with respect to its stock (a result that many believe already applies to such derivatives under current law). Tax-free treatment would not apply, however, where a corporation acquires its stock and, as part of the same plan, enters into a forward contract on its stock that has a forward price greater than the value of the stock at such time. In that case, the corporation would be required to include the excess as OID-like ordinary income over the term of the forward contract.

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11 This would generally be the case where (1) the fair market value of the new debt is less than the fair market value of the old debt as of its original issue date and (2) the new debt or old debt is treated as "publicly traded" under Treasury Regulation Section 1.1273-2(f) at the time of the modification.

12 In contrast, the 2013 FP Draft would have mandated the use of the average basis method in all cases.

- **Tax accounting proposals for pools of receivables.** Certain payments received on a pool of receivables (*e.g.*, late payment fees, cash advance fees and interchange fees) would be required to be included in income when received and not treated as giving rise to OID.
- **Repealed tax preferences for bond issuances.** The Discussion Draft would repeal a number of existing tax preferences for bond issuances, including (1) the interest exclusions for private activity bonds and advance refunding bonds and (2) all authority for issuing tax-credit bonds and advance-pay bonds.

Partnerships

Chairman Camp had previously released a "discussion draft" of a bill relating to the taxation of small businesses on March 12, 2013 (the 2013 Small Business Draft).[13] The 2013 Small Business Draft predominantly addressed the taxation of partnerships and S corporations. The 2013 Small Business Draft included two alternative proposals for reforming the taxation of partnerships and S corporations. The first option provided for limited reform and contained some significant modifications to the current regimes applicable to partnerships and S corporations. The second option provided for fundamental reform and would have replaced the current regimes applicable to partnerships and S corporations with a single unified regime.

The Discussion Draft provides for more targeted changes to existing law, along the lines of the first option in the 2013 Small Business Draft, and does not attempt to fundamentally change the tax treatment of partnerships and S corporations. Of the many provisions targeting partnerships, those most likely to have a significant impact on partnerships and their partners include:

Treatment of carried interest as ordinary income. The Discussion Draft includes a new proposal designed to recharacterize certain capital gain with respect to an "applicable partnership interest" as ordinary income. This proposal varies significantly from prior "carried interest" proposals circulated during the past seven years, introducing new terminology, a modified scope and a different set of operative rules. The current carried interest proposal applies to a narrower category of partnerships, with an obvious focus on private equity and venture capital. Specifically, the proposal applies only to partnership interests received or held in connection with the regular conduct of a trade or business consisting, in whole or in part, of (1) raising or returning capital, (2) investing in or disposing of trades or businesses (or identifying trades or businesses for such investing or disposition) and (3) developing such trades or businesses. Unlike some prior proposals, which generally recharacterized all or a specified percentage of a holder's capital gain as ordinary income, the new carried interest proposal applies a rough justice approach, whereby capital gains above a certain formulaic limitation linked to the amount of "invested capital" in the partnership retain their character as capital. This approach potentially allows for a significant amount of capital gains to retain their character to the extent that an applicable partnership's returns and/or appreciation exceed such limitation. It also may address the concern raised by prior proposals that gain on the sale of a partnership interest attributable to the partnership's "enterprise value" should continue to merit capital gain treatment. Nevertheless, it remains possible that the proposal could have the effect of recharacterizing enterprise value in particular cases, depending on the facts and how certain of the proposal's terms (such as "invested capital") are defined and clarified in any subsequent legislation. In addition, although partnerships that simply hold real estate may fall outside the proposal, it appears that many partnerships in the real estate industry with broader activities could still fall within the scope of the type of partnerships to which the proposal could apply.

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13 *See* "House Ways and Means Proposal Would Change the Tax Treatment of Partnerships and S Corporations," *available at* http://www.skadden.com/sites/default/files/publications/House_Ways_and_Means_Proposal_Would_Change_the_Tax_Treatment_of_Partnerships_and_S_Corporations.pdf.

Publicly traded partnerships limited to mining and natural resources industries. Under current law, partnerships whose equity is publicly traded (publicly traded partnerships or PTPs) generally are subject to entity level tax as if they were corporations unless 90 percent or more of their income constitutes "qualifying income." Under the Discussion Draft, the current definition of "qualifying income," which includes income from dividends, interest, rent and gains from the sale of real property, would be limited to income derived from mining and natural resources activity.[14] Effectively, if enacted in its current form, this provision would limit partnership treatment of PTPs to those in the oil and gas industry, and PTPs in other industries, such as shipping and transportation, infrastructure, real estate and financial services, would become subject to tax as if they were corporations. Prior versions of PTP legislation introduced in Congress over the last several years but not ultimately enacted had been more narrowly targeted at financial services PTPs. The Discussion Draft provision would be effective for taxable years beginning after December 31, 2016, and, significantly, there is no "grandfathering clause" for existing PTPs. The lack of a grandfathering clause is surprising given that this proposal would have a significant adverse impact on existing PTPs, many of which were formed years ago, and their investors.

Repeal of exemption from self-employment tax for limited partners. Under current law, self-employment tax is imposed on income derived by an individual from any trade or business carried on by the individual, including the individual's distributive share of income from a partnership trade or business. The self-employment tax is imposed at the same rates as the employment tax on wages.[15] The self-employment tax is not imposed on passive investment income, including dividends, interest and capital gains.[16] Of particular note, self-employment tax also is not imposed on the distributive share of income of "a limited partner, as such," other than guaranteed payments for services actually rendered. As a result of this exception, many limited partners in service partnerships take the position that their distributive share of partnership income is exempt from self-employment tax, regardless of the fact that the partner may provide a substantial amount of services to the partnership and the nature of the underlying income as services income.[17] The Discussion Draft would repeal this exemption, effectively subjecting a partner's distributive share of partnership trade or business income to self-employment tax.[18] It appears that a partner's share of partnership net capital gain that would be recharacterized as ordinary income under the carried interest provisions of the proposals would also be subject to self-employment tax. Partners who materially participate in the trade of business of the partnership would be allowed a deduction, however, that would treat 30 percent of their combined compensation and distributive share of the partnership's income as earnings on invested capital not subject to self-employment taxes. Partners who do not materially participate in the trade or business would be entitled to a 100 percent deduction, so that no portion of their distributive share would be subject to self-employment tax.

Repeal of technical termination rules. Under current law, a partnership is considered "technically terminated" if within any 12-month period, there is a sale or exchange of 50 percent or more of the

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14 Under the Discussion Draft, qualifying income would include income "from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or related products), or the marketing of any mineral or natural resource (including geothermal energy and excluding fertilizer and timber) or industrial source carbon dioxide."

15 Self-employed individuals may deduct one half of self-employment taxes for income tax purposes under section 164(f).

16 The recently enacted 3.8 percent Medicare may separately apply to this type of investment income, however.

17 For years, there has been uncertainty regarding the extent to which this exception applies to partners in other forms of state law partnerships or entities treated as partnerships for U.S. federal income tax purposes, such as limited liability companies. In 1997, the IRS proposed regulations that would have expressly applied the exemption to a member of a limited liability company if the member devoted less than 500 hours and was not a service partner in a service partnership. The regulations were controversial, led to the Senate passing a non-binding "Sense of the Senate" Resolution recommending that Treasury withdraw the regulations, and were ultimately never finalized.

18 In addition, the Discussion Draft would subject a shareholder's distributive share of S corporation income to self-employment tax.

total interest in partnership capital and profits. Under the Treasury regulations, a technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners. The Discussion Draft would repeal the technical termination rules. In some respects, this is a welcome change, as a technical termination can have adverse consequences for a partnership and its partners. For example, a technical termination closes the partnership's taxable year, requiring the partnership to file two partnership tax returns with respect to the calendar year and restarts the period for depreciation of the partnership's assets. However, affirmatively causing a partnership to undergo a technical termination can sometimes be a useful tax planning tool. For example, a technical termination also terminates a partnership's tax elections, such as a section 754 election or section 704(c) allocation method, which otherwise could not be changed or revoked without the IRS's permission.

Other notable proposals. Other proposed tax law changes include:

- The Discussion Draft would repeal the rules relating to guaranteed payments. All payments made by a partnership to a partner would be treated as either (1) a payment from the partner's distributive share of partnership income or (2) as a payment made to a nonpartner.
- Adjustments to the basis of partnership property would become mandatory in connection with distributions of partnership property to partners and transfers of partnership interests by partners, regardless of whether the partnership has made a section 754 election. In addition, lower-tier partnerships would be required to make corresponding basis adjustments at the time adjustments are made by an upper-tier partnership.
- The rules relating to "hot assets" would be modified to eliminate the requirement that inventory be "substantially appreciated" in value such to trigger gain recognition in certain partnership distributions.
- The seven-year time limitation in the so-called "anti-mixing bowl" rules of sections 704(c) and 737 would be eliminated, which would prevent "mixing bowl" partnerships from ever being unwound in a tax-deferred manner. This change only would apply to property contributed to a mixing-bowl partnership after December 31, 2013.

International Tax

The international tax aspects of the Discussion Draft broadly resemble those contained in Chairman Camp's 2011 International Tax Reform Discussion Draft (the 2011 Draft)[19] with several exceptions, notably tighter interest limitation rules for inbound multinational corporations and the adoption under Subpart F of base erosion Option C from the 2011 Draft with a formulaic definition of "foreign base company intangible income" that may apply in unexpected circumstances.

The two principal aspects of the Discussion Draft — a participation exemption with an expanded CFC regime — would eliminate the current system of worldwide taxation with deferral and replace it with a hybrid exemption/current taxation system, whose impact on U.S.-parented multinational corporations will undoubtedly vary on a case-by-case basis. While the reforms would end the lock-out of foreign earnings that multinational corporations face under current law, it does so at a cost to many taxpayers.

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19 *See* "2012 Insights: Regulatory," *available at* http://www.skadden.com/sites/default/files/publications/Skadden_2012_Insights_Regulatory_0.pdf.

Interest Limitation Rules

The Discussion Draft contains two interest limitation provisions that limit the ability of both U.S.- and non-U.S.-parented multinational groups to reduce their U.S. taxable income through otherwise deductible interest payments.

For U.S.-parented multinational groups, the U.S. members of the group would be allowed net interest expenses of at least 40 percent of adjusted taxable income (a measure of income that approximates EBITDA) and potentially more to the extent the U.S. group is not significantly overleveraged vis-à-vis its foreign affiliates, based on relative debt-to-equity ratios. For these purposes, a corporation's equity is measured using the tax basis of assets, which can differ significantly from equity as measured on either a fair market value or book basis. The outcome of the "over-leveraging" test may thus differ from what might be expected if more conventional capital market measures of debt-to-equity were used.

For a foreign-parented multinational, the Discussion Draft would reduce the section 163(j) limitation on interest paid to related foreign persons from 50 percent of adjusted taxable income to 40 percent. This latter provisions is new to the Discussion Draft, as the 2011 Draft did not contain any such revision to section 163(j).

This provision was presumably included in the new proposal both to raise revenue and to achieve greater parity between U.S.- and non-U.S. parented multinationals with respect to the treatment and tax effects of debt.

Participation Exemption

At the heart of the Discussion Draft's international tax proposals is the proposed adoption of a "territorial system" — *i.e.*, one in which foreign earnings would be taxed where earned and not in the United States. Whereas under current law dividends paid by foreign subsidiaries to U.S. corporate shareholders are subject to U.S. taxation (generally with a credit for foreign taxes paid on that income), under the new system, dividends paid by a foreign corporation to its 10 percent or greater U.S. corporate shareholders generally would be 95 percent exempt from U.S. taxation, yielding an effective U.S. tax rate of 1.25 percent, with no credit under section 901 or 902 for any foreign taxes (including dividend withholding taxes) imposed on such income.

This proposal is consistent with the trend in international taxation among other large developed countries, many of whom have long had territorial tax systems, and several of whom – *e.g.*, the U.K. and Japan – have adopted such systems in the past few years.

One-Time Transition Tax on Accumulated Foreign Earnings

The Discussion Draft imposes a one-time transition tax on previously untaxed accumulated foreign earnings. The tax is imposed at one of two rates: an 8.75 percent rate on accumulated earnings and profits (E&P) to the extent of the cash and cash equivalents held by the foreign corporations, and a 3.5 percent rate on the balance of the E&P. This two-tier system varies from the one-tier 5.25% rate proposed in the 2011 Draft. The two-tier rate is designed to be less burdensome for corporations that have reinvested their foreign earnings in business assets, and more so on those who have not done so and who have instead accumulated significant amounts of foreign-held cash. A foreign tax credit is permitted for taxes paid on the taxable portion of these earnings.

In another departure from the 2011 Draft, under the Discussion Draft, taxpayers may net the positive E&P of one foreign subsidiary and the deficit of another, such that the transition tax is only imposed on a group's net positive E&P. In addition, the transition tax is payable over eight years, with a back-loaded payment schedule that provides for smaller payments in years one through five (8 percent of the tax liability in each

such year) and larger payments in years six through eight (15, 20 and 25 percent in each of years six, seven and eight, respectively).

Once subject to this transition tax, the earnings would not be subject to further taxation upon repatriation to the United States.

Expanded Subpart F Regime

Foreign Base Company Intangible Income

The Discussion Draft's changes to Subpart F are broadly consistent with the base erosion Option C contained in the 2011 Draft, which focused on the current taxation of CFC income attributable to intangible property.

As was the case under the prior Option C, CFC intangible income that is attributable to U.S.-destined goods and services would be subject to full, current U.S. taxation; other CFC intangible income would be subject to current U.S. taxation at a reduced 15 percent rate — in each case with a credit for foreign taxes paid on such income. Domestic corporations likewise would enjoy a reduced 15 percent rate on intangible income attributable to their foreign sales, thus placing domestic corporations on an equal footing with foreign affiliates. In determining whether sales or services are U.S.-destined, related party sales would be disregarded, and if the seller or service provider knows or has reason to know that the good or service will ultimately be consumed in the United States, then the sale or service is treated as U.S.-destined even if sold or provided in the first instance outside the United States.

The most notable change in the Discussion Draft's base erosion proposal is the adoption of a formula for measuring "intangible income." Under the new proposal "intangible income" is the excess of a CFC's gross income over 10 percent of the basis of its tangible property. In essence, the proposal, rather than being a tax on "intangible income," is a tax on "excess returns," with "routine returns" measured — in some sense — as a return on assets.

While the use of a formula to measure "intangible income" presumably was designed with certainty and administrative ease in mind, the formula's use of tax basis in tangible property as the starting point for measuring excess returns presumably leads to dramatically varying results depending on the nature of any given foreign corporation's business. In particular, foreign corporations whose businesses are not asset intensive but which have significant costs (*e.g.* labor costs or R&D expenses) may have significantly higher levels of "intangible income" because no mark-up is afforded on such costs when measuring "intangible income."

Also of note is the Discussion Draft's ordering rule that, pursuant to a formula, would treat other categories of Subpart F income as taking priority — either wholly or in part — over foreign base company intangible income. That can potentially lead to unusual — and perhaps unintended — results. For example, a CFC that earns foreign base company sales income — which under the new proposal is only taxed at 12.5 percent — may not face full taxation on its foreign base company intangible income, even where such income is attributable to U.S. sales and services and would thus have been taxed at the full 25 percent rate absent this ordering rule.

Other Subpart F Changes

The Discussion Draft includes a number of other changes to Subpart F including:

- Reduced Taxation of Foreign Base Company Sales Income
    - Foreign base company sales income would be taxed at a 12.5 percent rate, or be exempt altogether if earned by a CFC that is treaty-qualified.

- Permanent Extension of CFC Look-Through
  - The Discussion Draft extends on a permanent basis the perennially expiring look-through rule of section 954(c)(6).
  - Notably, as a general matter, the Discussion Draft *does not* interfere with the current check-the-box regime.
- Limited Extension of Active Finance Exception
  - The Discussion Draft extends the active finance exception, but only for five years, and only for income subject to at least a 12.5% rate of foreign tax; active finance income subject to a lower foreign tax rate is subject to taxation in the United States at a 12.5% rate.
- Restrictions on Cross-Crediting of High-Taxed Subpart F Income
  - The Discussion Draft modifies the high-tax kickout rules under Subpart F to exclude any income subject to a rate of foreign tax at least equal to the U.S. rate that would have applied to such income. Effectively, this prevents taxpayers from cross-crediting taxes paid on high-taxed Subpart F income against the U.S. taxes owed on lower-taxed Subpart F income.

Changes to Foreign Tax Credit Rules

The Discussion Draft also contains a number of changes to the foreign tax credit regime, including:

- Expansion of the Passive Basket
  - The Discussion Draft relabels the "passive" foreign tax credit limitation basket as the "mobile" basket, and includes in it passive income as well as foreign base company sales income and foreign company intangible income.
- No Indirect Expense Allocation
  - For purposes of calculating the foreign tax credit limitation, only directly allocable expenses are allocated to foreign source income. The introduction of the thin-capitalization rules discussed above together with the 95 percent — rather than 100 percent — exemption for foreign subsidiary dividends are presumably meant to address the issue of expense allocation, which in any event is of lesser significance given the lesser role played by foreign tax credits under the proposed participation exemption regime.
- No Foreign-Sourcing of Inventory Income
  - The Discussion Draft would eliminate the sourcing rule that treats exported property as partly U.S. and partly foreign source, and instead source such income based entirely on the place of production. This change will limit the ability of taxpayers to cross-credit taxes paid on other income against such export income, which again is likely of reduced significance in any event under the proposed participation exemption system.

The Discussion Draft's international proposals represent a compromise between the desire to enhance the competitiveness of U.S. multinationals and eliminate the current foreign earnings lockout effect by moving towards a territorial tax system that is more consistent with those of our major trading partners, and on the other hand, the need to maintain revenue neutrality and avoid the additional base erosion that might be expected under a territorial system. In bridging that divide, the Discussion Draft

focuses on two primary targets for enhanced taxation — intangible property and interest expense. But while the Discussion Draft's restrictions on interest deductions apply equally to both U.S.- and foreign-parented multinationals, the expanded Subpart F regime applies only to U.S.-parented groups, potentially putting U.S.-parented multinationals at a competitive disadvantage vis-à-vis their foreign-parented competitors, who are generally not subject to such expansive CFC regimes. While the tradeoffs inherent in the proposal may roughly balance as a general matter, among those affected by the proposals there will undoubtedly be winners and losers.

Additional Noteworthy Proposals

Excise tax on "systematically important financial institutions" (SIFIs). The Discussion Draft proposes a new excise tax on SIFIs. As defined in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), SIFIs are all banking organizations with more than $50 billion in total assets and include a small group of "non-bank financial companies" that have been designated as systemically important by the Financial Stability Oversight Council. For purposes of applying the new tax, the Discussion Draft effectively modifies the threshold employed by the Dodd-Frank Act so that the new tax applies only to those SIFIs whose assets exceed $500 billion. The annual tax would total 14 basis points of assets in excess of $500 billion. If enacted, the tax would raise approximately $86.4 billion over the next 10 years. Presumably the tax has been proposed to help fill the gap in the lost revenue resulting from the overall corporate rate reduction and other reform proposals. The tax is similar to the proposals put forth by the Obama administration in the annual budget each year since 2010, with some notable differences.

The limitation in the Discussion Draft applying the tax only to SIFIs that have more than $500 billion in total assets stands in contrast to the administration's budget proposals that would apply a tax to certain entities with more than $50 billion in total assets. The Discussion Draft would apply to a covered institution's "excess consolidated total assets," which are defined as the excess of the institution's "total consolidated assets," as defined in section 165 of the Dodd-Frank Act, over $500 billion. The Discussion Draft does not provide for any exceptions or exemptions for the type of assets subject to the tax. In contrast, the administration proposals, aimed at the most highly levered banks, would apply to "covered liabilities," which generally include the firm's assets less its Tier 1 capital and FDIC insured deposits (and insurance policy reserves, as applicable). Thus, although the number of banks subject to the tax may be fewer under the Discussion Draft, the tax base is broader than the base used in the administration's budget proposals.

While the various administration budget proposals since 2010 varied the rate of the tax from 7.5-17 basis points, the Discussion Draft is toward the higher end of that range at 14 basis points. The Discussion Draft is expected to raise more revenue, at least in part, because it does not offer any discount on the tax rate for less-risky assets. In contrast, some of the administration's proposals, including the proposal for FY2015 , provided for a 50 percent discount for stable sources of funding, such as long-term liabilities. The Discussion Draft provision is also permanent, whereas the administration's proposals would have imposed the tax for a 10-year finite period (and were originally linked to the repayment of Troubled Asset Relief Program payments). Although the Discussion Draft does not address deducibility, presumably the tax imposed would be deducted against the corporate income tax base of the affected institution as was contemplated by earlier proposals from the administration.

It is expected that the SIFI tax will be met with resistance from the financial and insurance sectors. But the inclusion of the SIFI tax in the Discussion Draft signals that the affected institutions may simply be one of the easier targets for revenue generators that would be necessary to support the other provisions in the Discussion Draft. However, because financial institutions often pay higher effective tax rates than companies in other sectors as a result of taking fewer deductions and credits, the overall net effect of the new tax

on the covered institutions could be mitigated if enacted along with the other reform proposals. There is a risk, however, that the Discussion Draft's sticks — such as the SIFI tax — could be implemented without the accompanying carrots, such as the reduced corporate rate. In addition, by focusing on only the largest financial institutions, the Discussion Draft narrows the pool of institutions that are subject to the tax, which may make it more difficult for such institutions to pass on the cost of the tax because unaffected competitors will not be faced with the same issue.

Worker Classification. The Discussion Draft provides a new statutory safe harbor for classifying a worker as an independent contractor. The details of the safe harbor do not appear to deviate significantly from the administrative practices under which the IRS and taxpayers have operated for over 30 years (since the moratorium on published guidance enacted in section 530 of the Revenue Act of 1978). But the Discussion Draft takes a very different approach than the Obama budget proposal, which would authorize the IRS to require prospective reclassification of workers as employees and lift the moratorium on guidance.

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Concluding Observations

The Discussion Draft demonstrates that it is possible to significantly reduce tax rates in a revenue neutral manner — which was a key aspect of the 1986 reform effort — but it also demonstrates that there is a steep price to be paid in exchange for that rate reduction. When Congress takes up the Discussion Draft, or other tax reform proposals, it will have to decide whether it is willing to pay the price necessary to achieve the types of rates that the Discussion Draft proposes, or whether it would prefer a more modest rate reduction in exchange for retaining some of the provisions that the Discussion Draft would scuttle.

In the current climate, and given the lack of legislative action to date (other than hearings and discussion drafts), there is little or no chance that tax reform will move forward this year. But that does not mean that taxpayers should ignore what Chairman Camp has proposed. By releasing a comprehensive draft, Chairman Camp effectively has challenged others to come up with alternatives to his proposals. This means that many of the ideas included in his Discussion Draft will be part of the tax reform debate over the next few years. Even though Chairman Camp has announced he will retire at the end of 2014, his detailed proposals and draft legislative language, like the Bradley-Gephardt and Kemp-Kasten proposals of the early 1980s, provide a roadmap for how Congress might address some of the difficult issues presented by tax reform. This conclusion is reinforced by the overlap among Chairman Camp's Discussion Draft, the proposals offered by then-Senate Finance Committee Chairman Max Baucus (D-Mont.), and proposals included in President Obama's budgets.

In addition, if one assumes that, in the absence of tax reform, before the end of the year Congress will want to extend some of the expiring (or expired) business tax provisions, pursue repeal of the medical device excise tax, provide additional relief to low income taxpayers as proposed by the president, or make other tax changes that cost revenue, then taxpayers who might be affected by any of the revenue raisers included in the Discussion Draft need to focus now on how those provisions might apply to their businesses, and what can be done to mitigate or avoid any potential negative consequences. Moreover, to the extent that the Discussion Draft includes immediate effective dates, companies will need to carefully weigh the risk that those effective dates will remain unchanged if the provisions ultimately are enacted. Transition relief, often a critical component of tax legislation, rarely is included in first drafts of legislation but rather must be sought during the legislative process.