House Considers Significant Tax Legislation

On October 25, Chairman Charles B. Rangel of the House Ways and Means Committee introduced the "Tax Reduction and Tax Reform Act of 2007" (H.R. 3970) (the "Bill"). If enacted, the Bill would eliminate the alternative minimum tax for individuals, lower the regular corporate tax rate from 35% to 30.5%, and extend certain tax benefits for individuals and small businesses. To pay for these benefits, the Bill would raise the tax rate for high-income individuals, increase taxes on "carried interests," eliminate deferral for most compensation paid by off-shore hedge funds to their managers, and end certain tax benefits for controlled foreign corporations, manufacturing activities, and certain other businesses.

The Bill itself is not expected to pass in its entirety in this Congressional session. Certain provisions, such as a one-year AMT patch, one-year tax-benefit extensions, and corresponding revenue offsets that directly affect our clients, are expected to be introduced separately and quickly adopted by the House of Representatives. The Senate Finance Committee is expected to propose this week a one-year AMT patch and a two-year extension of the tax extenders with fewer revenue offsets.

Highlights of the Bill are described below. Except as otherwise noted, the effective date for each provision is for tax years beginning after 2007.

Private Equity/ Hedge Funds

- **Tax Carried Interest as Ordinary Income.** Like earlier proposed legislation, the Bill would tax carried interests in investment partnerships as ordinary income. The Bill would add anti-abuse provisions, including a rule designed to prevent avoidance of the legislation through partner loans, and a rule extending the legislation to certain interests in non-partnership entities. An extraordinary 40% penalty, with no exception for "reasonable cause," would apply to certain underpayments due to avoidance of the legislation. The effective date is left unspecified in the Bill text available to date, but the Joint Committee on Taxation revenue estimate assumes that the provision is generally effective for tax years ending after the date of first committee action.
- **Eliminate Hedge Funds Fee Deferral.** Following legislation introduced this fall, the Bill would require any person providing investment management services to a foreign corporation or partnership with material foreign or U.S. tax-exempt investors to report vested deferred compensation (i.e., compensation not conditioned on the future performance of substantial services) on a current basis. If the deferred compensation cannot be ascertained on the vesting date, it must be reported when ascertainable, and an interest charge and a 20% penalty would then apply.
- **Eliminate UBIT on Hedge Fund Investments.** Tax-exempt institutions that invest as limited partners in leveraged securities partnerships would no longer have to treat a portion of the partnerships' income and gains as "unrelated business taxable income" for tax years beginning after the date of enactment of the change. Like legislation previously introduced in the House, the Bill would limit relief to partnerships and would not apply to direct debt-financed investments by tax-exempts. Unlike the earlier legislation, the Bill would not condition relief on the partnership's compliance with the tricky "fractions rule."
- **Impose Self-Employment Tax on Pass-Through Income.** S corporation shareholders and all partners (including limited partners and LLC members) in entities engaged primarily in a service business would be subject to self-employment tax on their shares of the entity's income, except to the extent that they do not themselves provide substantial services in that business.

Business Tax Reform

- **Reduce Corporate Tax Rate on Domestic Income.** The top corporate marginal rate would be reduced from 35% to 30.5% for taxable years beginning after 2008.
- **Reduce Corporate Tax Deductions.** For the same taxable years, the Bill would eliminate the deduction for domestic production activities, and would reduce the intercorporate dividends-received deduction from 80% to 70% in the case of less than 80% owned corporations and from 70% to 60% in the case of less than 20% owned corporations. For assets acquired after the date of enactment, the amortization period for purchased goodwill and other intangibles would be increased from 15 years to 20 years.
- **Repeal LIFO and LCM.** For tax years beginning after the date of enactment, the Bill would repeal the last-in first-out (LIFO) and lower of cost or market method (LCM) inventory tax accounting methods, with eight-year spread transition rules.
- **Help Small Businesses.** Existing small business expensing rules would be permanently extended for depreciable tangible property for tax years beginning after the date of enactment and for computer software placed in service after the date of enactment.
- **Codify Economic Substance Doctrine.** The Bill would codify the "economic substance doctrine" for transactions after the date of enactment and add a 20% penalty on understatements attributable to a transaction lacking economic substance effective for tax years beginning after the date of enactment.

International Provisions

- **Defer US Expenses and Deductions Allocated to Foreign Income.** The Bill would require a U.S. shareholder owning 10% or more of a "controlled foreign corporation" (CFC) to defer all deductions for expenses "allocable" to its foreign earnings (based on the percentage of the taxpayer's worldwide income earned in CFCs) until the CFC repatriates such foreign income through dividends or "phantom income" inclusions under the CFC regime. Foreign taxes would be deemed paid as if all CFCs were consolidated as a single foreign corporation, effectively averaging the tax rates imposed on CFC income in low-taxed and high-taxed countries.
- **Limit Tax Treaty Benefits.** The Bill would override current U.S. income tax treaties to impose U.S. withholding taxes on deductible US-source payments (such as interest or royalties) made after the date of enactment to foreign related parties, where both the U.S. payor and foreign recipient are owned by a foreign parent corporation that is not resident in a tax treaty jurisdiction.

Regulated Investment Companies

- **Extend Look-Through Treatment to Foreign Shareholders of Mutual Funds.** The Bill would extend for one year the current look-through tax treatment of foreign shareholders of regulated investment companies ("RICs") for interest-related and short-term capital gains dividends.
- **Extend Exemption from Withholding for Certain Distributions to Foreign Shareholders.** The Bill would also extend for one year the current exemption from withholding for certain distributions to foreign investors owning no more than 5% of a domestically controlled RIC that invests primarily in real property-related assets (including REITs).
- **Require Basis Reporting by Brokers (Including Mutual Funds) on Sales of Publicly Traded Securities.** Mandatory cost-basis reporting by brokers would be required for stock acquired after January 1, 2009 and for other public market securities acquired after January 1, 2011.

Individuals

- **Extend Credits and AMT Exemption Followed by Repeal of AMT.** The Bill extends for one year the current increase in AMT exemption and provisions allowing nonrefundable personal credits to the full extent of an individual's regular and alternative minimum tax. The Bill would repeal the AMT for years beginning after 2007.
- **Impose Surtax on Certain High-Income Taxpayers.** A 4% surtax would be imposed on modified adjusted gross income (increased by investment interest expense) of married couples above $200,000 and of individuals above $150,000. The surtax would be increased to 4.6% for modified adjusted gross income of married couples above $500,000 and of individuals over $250,000.
- **Keep Limitation on Itemized Deductions and Phase-out of Deductions for Personal Exemptions.** For married couples and individuals with adjusted gross income above $500,000 and $250,000, respectively, the Bill would restore the overall limitation on itemized deductions and the phase-out of the deduction for personal exemption to the levels that existed prior to the enactment of the "Economic Growth and Tax Relief Reconciliation Act of 2001."
- **Increase of 2% Floor on Miscellaneous Itemized Deductions.** The current 2% floor on miscellaneous itemized deductions would be increased to 5% for adjusted gross incomes above $200,000 for married couples and $150,000 for individuals.
- **One-Year Extenders.** Numerous expiring or expired tax provisions would be extended for one year, including the research credit, the elective deduction for state and local sales taxes, the above-the-line deduction for qualified tuition and related expenses, and various charitable giving incentives, including the popular IRA rollover.

Contact Information

For more information concerning these developments, please contact a member of the Tax & Benefits Department.