

The Obama tax proposals

What they could mean
for your business



Summary of key points

- ▶ The proposed budget outline indicates shifts in tax policy that would represent the biggest change of course for the nation since Ronald Reagan took office in 1981.
- ▶ The budget outline provides \$170 billion in tax relief for businesses.
- ▶ The Obama Administration expects to raise \$210 billion in revenue over the next 10 years in international tax changes.
- ▶ The budget proposals eliminate many of the existing tax preferences available to the US oil and gas/chemical industries.
- ▶ Corporate executives must ensure that their tax functions are included in all discussions of business strategy.
- ▶ Companies that have stood on the sidelines until now should consider getting involved in the legislative process to make their voices heard.
- ▶ Business leaders need to understand that failure to prepare could have substantial adverse consequences, and that the time to take action is now, before the budget details are final.

It is imperative that companies be ready for potentially large-scale changes that could arrive with unusual speed.

Changes ahead

The budget outline released by the Obama White House on 26 February provides a glimpse of the new Administration's plans for the next four years – and possibly beyond. Details are still forthcoming, but the outline signals clearly the Administration's main areas of focus. It also indicates potentially seismic shifts in tax policy that, if enacted, would represent the biggest change of course for the nation since Ronald Reagan took office in 1981.

President Obama has an ambitious tax agenda, his position bolstered by a Congress with strong majority control. Revenue pressures are high, with the federal deficit for fiscal 2009 forecast at \$1.75 trillion, and baseline federal spending on the rise. Pay-as-you-go rules are in effect, meaning that all new spending must be offset with corresponding increases in revenue. Against this backdrop, the Administration is offering businesses both significant tax relief (\$170 billion) and significant tax increases (\$330 billion). On balance, the tax burden is shifting toward businesses and high-income individuals, a trend that will likely alter the tax environment for US businesses both domestically and abroad.

Signs of change are already evident. On 24 March, the White House announced plans to establish a task force that will examine the corporate and individual income tax systems and recommend ways of streamlining the tax code and preventing tax evasion. The task force will submit its recommendations by December 2009, and its proposals could be incorporated into the FY 2011 budget proposal. Dramatic changes affecting international business activity seem particularly likely.

Equally important, the Administration appears to be using the current economic crisis to accomplish its desired changes in an unusually short period of time. This government has already shown itself capable of enacting major legislation quickly in response to economic circumstances – the February 2009 economic stimulus package being a case in point. For that reason, the pace at which change can be expected to unfold this year may be just as remarkable as its scope.

In such an environment, corporate executives must ensure that their tax functions are included in all discussions of business strategy. Companies that have stood on the sidelines until now should consider getting involved in the legislative process to make their voices heard. Above all, business leaders need to understand that failure to prepare could have substantial adverse consequences, and that the time to take action is now, before the budget details are final. This article reviews the highlights of the proposed budget, and suggests steps companies can take today to get ready for whatever changes may lie ahead.

Tax reductions

The budget outline provides \$170 billion in tax relief for businesses, the main elements of which are:

- ▶ **Permanent extension of the research tax credit.** Congress created the credit in 1981 and since then has allowed it to lapse nearly a dozen times, only to reinstate it later. Businesses have long wanted to make the credit permanent in order to facilitate tax planning, but the government has resisted because the credit takes away substantial tax revenue. By proposing a permanent research tax credit, the Administration is signaling the weight it attaches to stimulating innovation, especially in green technology (cleantech). If this proposal becomes law, companies will have an easier time budgeting for research and development.
- ▶ **Extension of Net Operating Loss (NOL) carryback.** The measure would provide welcome relief to cash-constrained companies by letting them recoup taxes paid up to five years ago, during more profitable times. (Current law generally allows NOLs to be carried back only two years.) In particular, home builders, manufacturers and financial services companies would likely benefit. The NOL carryback extension was initially proposed in January as part of the economic stimulus package, but Congress subsequently decided to limit the measure to businesses with annual revenue below \$15 million. The President's budget proposes to extend the carryback to larger companies as well, consistent with the proposal's original intent.
- ▶ **Continuation of remaining "business extenders" through 2010.** This set of corporate tax breaks expires and must be renewed every few years. Businesses rely on these provisions being extended annually, which has generally happened. The Emergency Economic Stabilization Act of 2008 (EESA), passed by Congress last October, extended the provisions through calendar year 2009. The new budget could have allowed them to expire and picked up the additional revenue generated by the lapse. Instead, the provisions extended by EESA, such as the Subpart F provisions for active financing income and the look-through rule for payments among related controlled foreign corporations, appear to have another year under this budget. After 2010, however, the budget apparently assumes that none of them will be renewed.

Revenue raisers

International business activity

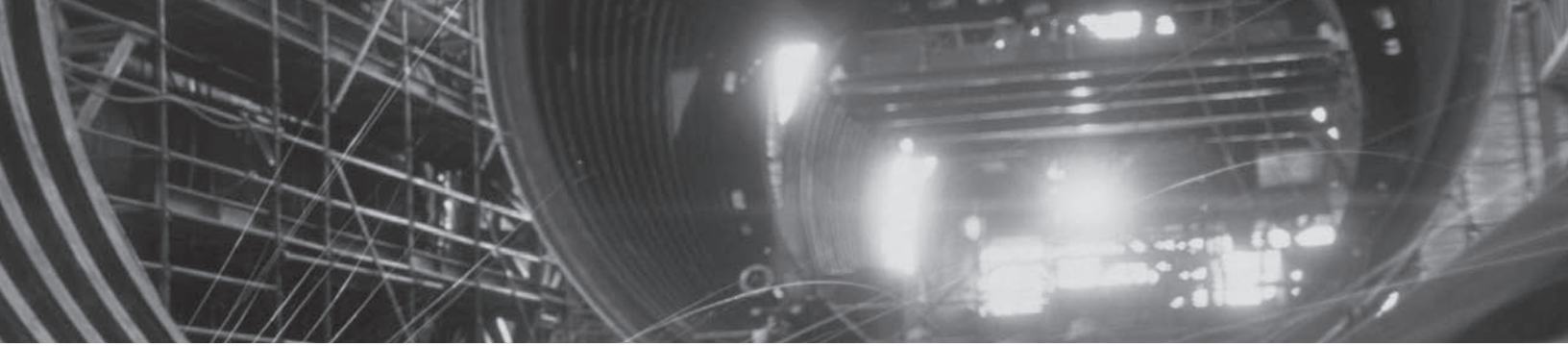
The Obama Administration's budget outline includes broad – though still to be defined – international tax changes. Details on the proposals are forthcoming, yet the Administration expects the changes to raise \$210 billion in revenue over the next 10 years, indicating that the proposed changes will be substantial. The main elements consist of implementing international enforcement and reforming deferral of income earned abroad:

- ▶ **Reforming deferral of overseas income.** Under the current US tax system, a company that generates active business income abroad is subject to foreign tax at the local rates. Only when the company repatriates the income in the form of dividends is it subject to US tax. This system of deferral allows US companies to compete with foreign companies that generally are not subject to home-country tax on their overseas earnings. The Obama Administration has proposed "reforming deferral." Exactly what is meant by that phrase is still unknown; however, statements by senior members of the Administration make it clear that one of the options being considered is proposing the complete repeal of deferral. Some US multinationals have come out strongly against the proposal. On 24 March 2009, the Business Roundtable and the National Association of Manufacturers wrote a letter to Congress, urging lawmakers to reject what it called "the Administration's proposal to repeal 'deferral.'"
- ▶ **Stepping up international tax enforcement.** President Obama, in a variety of settings, has called for addressing the issue of tax havens. As a US senator in 2007, he co-sponsored the Stop Tax Haven Abuse Act, a bill that was re-introduced in the House and Senate in March with new and broader provisions. Treasury Secretary Tim Geithner has gone on record supporting stricter enforcement of international tax laws. What this might mean in terms of specific proposals from the Administration is still unclear, but the Administration's FY 2010 budget outline – and public statements by members of the President's cabinet – make it apparent that international tax enforcement and provisions targeting tax haven entities or activities are part of the Administration's budget agenda. The reintroduction of the Stop Tax Haven Abuse Act and the release by the staff of the Senate Finance Committee of draft legislative proposals intended to improve tax compliance with respect to offshore transactions indicate that there is strong congressional interest in taking some legislative action in this area.

Domestic business activity

Proposed revenue raisers affecting domestic business are expected to raise about \$120 billion over the next 10 years. The main elements are as follows:

- ▶ **Repeal of last in, first out accounting.** Last in, first out (LIFO) is a widely used method of valuing inventory that tends to lower the taxable income a company reports – eliminating it would raise corporate taxes. LIFO repeal could gain support because the U.S. Securities and Exchange Commission (SEC) is considering the adoption of International Financial Reporting Standards (IFRS), which prohibit the use of LIFO. Under the SEC's proposed Roadmap, however, companies would have until at least 2014 to switch to another accounting method. The President's proposed budget would repeal LIFO in 2012, raising the issue of how companies would be affected by the switch, and what current considerations may be in order.
- ▶ **Taxing carried interest as ordinary income.** The new budget proposes to tax partnership carried interest at ordinary income rates. Prior proposals to tax carried interest stemmed in part from reports that income earned by managers in hedge funds and private equity funds was taxed at favorable capital gains rates, rather than ordinary income rates. Although it is based on prior bills, the new proposal would not be limited to those groups and could apply to a broad range of partnerships.
- ▶ **Codification of the economic substance doctrine.** US courts developed the doctrine as a test to determine whether a transaction has a legitimate business purpose beyond lowering a company's tax bill. The doctrine is designed to identify transactions that adhere to the letter of the tax code, but not the spirit; transactions that fail the test are deemed to be abusive tax shelters. On several occasions, Congress has proposed codifying the doctrine by inserting the courts' test into the Internal Revenue Code. These proposals ultimately were dropped from legislation, largely because of concern that they were too broad and would penalize legitimate business transactions. President Obama's proposal to codify the economic substance doctrine would raise more revenue than a similar proposal made in 2008 by Charles Rangel (D-New York), Chairman of the House Ways and Means Committee. This suggests that the President's proposal could be broader in scope than Chairman Rangel's. If so, more transactions could be affected.



► **Cap-and-trade system for carbon emissions.** One provision not listed as a tax increase on businesses in the proposed budget would raise \$646 billion by allowing the federal government to auction off carbon emission allowances. The Administration's budget assumes that the federal government will begin collecting significant revenue from a so-called cap-and-trade scheme in 2012. Part of the revenue would be used to pay for research into renewable energy, perhaps with a special emphasis on renewable energy transmission. Although no explicit taxes are associated with the cap-and-trade scheme, companies will have to reduce their carbon emissions to meet baseline standards set by the US Environmental Protection Agency (EPA), and this will raise their cost of doing business. Senate Majority Leader Harry Reid has said that Congress will pass a cap-and-trade bill by the congressional recess in August. Even if the bill does not pass, the cap-and-trade scheme could be created via regulatory proceedings at the EPA, which the US Supreme Court has ruled can regulate pollution under the terms of the Clean Air Act of 1990.

Top five proposed tax increases on business

1. **Implement international enforcement, reform deferral, and other tax reform policies (\$210 billion over 10 years)**
2. **Repeal LIFO (\$61 billion over 10 years)**
3. **Tax carried interest as ordinary income (\$23.9 billion over 10 years)**
4. **Reinstate Superfund taxes (\$17.2 billion over 10 years)**
5. **Repeal the Section 199 manufacturing deduction for oil and gas companies (\$13.3 billion over 10 years)**

Oil and gas/chemical industries

The Obama Administration's budget eliminates many of the existing tax preferences available to the US oil and gas/chemical industries. Many of the proposals in the budget have appeared as revenue raisers in previous bills, but not all at the same time. The primary tax breaks targeted for removal are:

- **Repeal the Section 199 manufacturing deduction for oil and gas companies.** To increase the sale of US-manufactured products, the federal government in 2004 began allowing US companies to take a 3% deduction for manufacturing based in the US. The new budget would take away this deduction from the oil and gas industries.
- **Levy excise taxes on Gulf of Mexico oil and gas production.** This proposal would end current tax breaks for companies producing oil and gas in the Gulf of Mexico, and would levy an excise tax on the area's oil and gas production.
- **Repeal the expensing of intangible drilling costs.** The proposal would end a deduction for "ordinary and necessary" business expenses such as buying fuel, making repairs, scouting out drilling sites and transporting supplies. Under the proposal, such intangible drilling costs would have to be capitalized.
- **Reinstate Superfund taxes.** The budget proposes reinstating taxes paid by businesses to Superfund, the environmental program created in 1980 to clean up abandoned hazardous waste sites or those whose owners could not pay for cleanup. Congress imposed these taxes on the oil and gas and chemical industries until 1995.

Executives should think hard about how the new budget might affect their company's tax position.

Time for companies to get off the sidelines

Faced with such sweeping potential change in the tax landscape, what can companies do to prepare? We suggest a strategy that consists of the following three steps:

Step one

Evaluate non-US operations and tax positions. Companies should begin gathering data in anticipation of potential significant changes in the international tax area. Some questions to ask:

- ▶ Where do we have foreign entities and foreign operations?
- ▶ Do we need all existing entities?
- ▶ Is there a potential to move an entity to a different location?
- ▶ Do our entity locations line up with where the company has substantive business?

To prepare for possible changes in the deferral of overseas income, companies will also want to get a handle on their international tax data, especially earnings and profits, and tax basis.

Step two

Evaluate the potential impact of legislation on tax planning and compliance, tax controversy and risk management, preparation of financial statements and transactions.

It is necessary to think hard about how the new budget might affect your company's tax position. Some questions to ask:

- ▶ What is potentially at risk?
- ▶ What might a Plan B look like, and what costs would be associated with implementing it?

Even some budget proposals that provide tax relief may require some difficult choices. For example:

- ▶ What steps would a company take to reap the advantages of a change in the NOL carryback rule?
- ▶ If the research tax credit becomes permanent, would that change the locations in which an organization carries out its R&D?
- ▶ Above all, has senior management communicated the potential impact of these changes to key members of the organization so that they can begin thinking and preparing as well?

Step three

Get involved in the legislative process. Many companies are reluctant to take part actively in the debate surrounding legislative issues. Executives may feel that their company is not big enough to justify a lobbying effort, or may simply have decided not to invest the time and resources necessary for such an effort. These are valid decisions. Nevertheless, the current situation could signal a major change in tax and economic policy, potentially altering the business landscape for years or decades to come. When big changes are afoot, it's not a good time to be a bystander.

Preparation is key

Whatever specific actions businesses take, they must move quickly. US budgetary law establishes legislative milestones in the spring and summer in order to fund the federal government for the fiscal year 2010, which begins on 1 October. In view of the economic situation and the President's popularity, the Administration and Congress may seek to expedite the budget process. Under the circumstances, it is imperative that companies be ready for potentially large-scale changes that could arrive with unusual speed. Preparation is the key to success. ►

To talk about how your business can prepare for the coming changes in tax policy, please contact:

Sean J. Ford, Director

Tax Knowledge & Client Connectivity/
National Tax Department

Ernst & Young
1101 New York Ave
Washington, D.C. 20005
United States of America
Office: 202-327-7113 | Cell: 703-623-8004

Fax: 1-866-263-1215

sean.ford@ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 135,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit www.ey.com.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither Ernst & Young LLP nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

© 2009 EYGM Limited.
All Rights Reserved.

EYG No. YY2187



Ernst & Young is committed to reducing its impact on the environment. This document is being published to PDF. Thank you for considering the environmental impact of printing this document.