

Green Book Provides Insight Into Administration's Tax Plans

By Michael J. Novogradac, CPA

Last month the Treasury Department released its Green Book, which lays out the long-anticipated specifics of the list of proposed tax increases President Obama included in his proposed budget for 2010. The Green Book contains many tax cuts and many tax increases. In the aggregate, President Obama's tax proposals are estimated to raise net revenue of about \$387 billion, with about \$62 billion dedicated to deficit reduction and about \$325 billion dedicated to health reform.

Among the several tax provisions addressed and of particular interest to the affordable housing tax credit community are extending the carryback of net operating losses (NOLs), codification of the economic substance doctrine, and taxation of carried interests as ordinary income. Community development activists are also encouraged by the inclusion of the extension of the New Markets Tax Credit in President Obama's 2010 proposed budget. There are numerous other tax increases and tax cuts that could have indirect impacts on the demand for tax credits.

NOL Carryback

The Green Book states that a temporary extension of the NOL carryback period would provide taxpayers in all sectors of the economy that experience such losses with the ability to obtain refunds of income taxes paid in prior years. These refunds can be used to fund capital investment or other operating expenses. The Green Book goes on to say that the Administration looks forward to working with the Congress to make a lengthened NOL carryback period available to more taxpayers.

This provision is of interest to the LIHTC and broader tax credit community because companies with NOL carryforwards cannot generally use tax credits, and therefore

are not generally in the market to buy tax credits. If these companies were able to carry back any NOLs they have, then they will not have those NOLs to carry forward and are more likely to owe federal income taxes over the nearer term, and, as such, more likely to invest in tax credits. The estimated revenue cost for 2009 to 2019 is \$18.5 billion.

Economic Substance

The common-law economic substance doctrine generally denies tax benefits from a transaction that does not meaningfully change a taxpayer's economic position, other than tax consequences, even if the transaction literally satisfies the requirements of the Internal Revenue Code. The Obama Administration's proposal is meant to clarify the economic substance doctrine and, in an effort to further deter transactions designed solely to obtain tax benefits, increase the penalty for transactions that lack economic substance.

Current law contains an accuracy related penalty that equals 20 percent of the tax underpayment. A separate 20 percent penalty applies to an understatement of income tax attributable to a "listed transaction" or a "reportable transaction" with a significant purpose of tax avoidance or evasion. A 30-percent penalty is levied if the taxpayer has not disclosed the transaction as required by law.

The proposed change would clarify that a transaction satisfies the economic substance doctrine only if it changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position and the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. The proposal would also clarify that a transaction will not be treated as having economic substance solely by reason of a profit potential unless the

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present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction.

The proposal would establish a 30 percent penalty on an understatement of tax attributable to a transaction that lacks economic substance, reduced to 20 percent if there was adequate disclosure of the relevant facts in the taxpayer's return. It would also deny any deduction for interest attributable to an understatement of tax arising from the application of the economic substance doctrine.

Any transaction entered into after the date of enactment would be affected and the denial of interest deduction would be effective for taxable years ending after the date of the enactment for those transactions entered into after that date. The estimated revenue raised for 2010 to 2019 is \$4.7 billion.

This provision represents a continuation of efforts over the last several years to codify the economic substance doctrine. In several of the previous efforts to enact a similar provision, supporters of codifying the economic

substance doctrine made clear that their efforts were not designed to and should not limit the ability of taxpayers to engage in transactions for the purpose of generating congressionally authorized tax credits, such as the low-income housing tax credit. The Green Book description of the proposal does not contain such a statement, albeit no one believes the omission was intentional or represented a policy decision. Rather, it is generally believed omission of such language from the Green Book was either an oversight, or a victim of brevity.

As codification language makes its way through Congress, we all need to ensure that it is made clear that codification of the economic substance doctrine does not limit the ability of investors to invest in tax credit transactions.

Carried Interests

As expected, the FY10 Green Book includes a plan to change the taxation of carried interest by applying ordinary income taxes to the "carry" or "promote" earned by the general partner in a partnership arrangement, in-

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Journal of Tax Credit Housing Information

Address all correspondence and editorial submissions to:

Jane Bowar Zastrow

Telephone: 415.356.8034

Address inquiries regarding advertising opportunities to:

Emil Bagalso

Telephone: 415.356.7917

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Novogradac & Company LLP
246 First Street, 5th Floor
San Francisco, CA 94105
E-mail: cpas@novoco.com



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cluding hedge funds and real estate partnerships. This proposal is similar to pending legislation (H.R. 1935) that the National Multi Housing Council (NMHC) has been opposing for months.

There is concern in the multifamily housing community that the proposed change in the taxation of carried interests will prove disruptive to the real estate industry. While the original focus of this tax change was the Wall Street hedge funds, opponents warn that an increase in the taxation rate of carried interests could adversely affect a number of industries, including real estate.

The NMHC warns that the change could have numerous unintended consequences, including exacerbating the nation's affordable housing shortage. If enacted, the changes in the taxation of carried interests could affect a new development's financial viability, NMHC says. According to NMHC, it will be particularly damaging to properties located in under-developed areas and could prevent much of the proposed new affordable housing from being built.

Under current law, a partnership is not subject to federal income tax. Instead, income and loss of the partnership flows through to its partners who must include such items on their tax returns. Any gain recognized on the sale of a partnership interest, whether received in exchange for property, cash or services, is generally treated as capital gain. Present law states that income attributable to a profits interest of a general partner is generally subject to self-employment tax except to the extent that the partnership generates types of income that are excluded from self-employment taxes, e.g. capital gains, certain interest and dividends.

In its proposal, the Administration says that although profits interests are structured as partnership interests, the income allocable to such interests is received in connection with the performance of services; therefore a service provider's share of the income of a partnership attributable to carried interest should be taxed as ordinary income and be subject to self-employment tax.

The present system, the Administration argues, creates

an unfair and inefficient tax preference and as a result the recent "explosion" of activity among large private equity firms increased the breadth and cost of this tax preference, allowing only some of the highest-income Americans to benefit from preferential treatment.

This proposal, broader than other such proposals passed twice by the House but blocked by the Senate and that affected only certain industries, would impact any type of business. It would tax as ordinary income, up to 39.6 percent under the Administration budget proposal, a partner's share of income on a "services partnership interest (SPI)," regardless of the character of the income. As a result, such income would not be eligible for the reduced rates that apply to long-term capital gains, now taxed at 15 percent. The proposal would also require that the partner pay self-employment taxes on such income.

It's also been suggested that the proposal as written implies that any partner who provides services to the partnership, such as lawyers and accountants, is subject to the rules. The proposal would be effective for tax years beginning after December 31, 2010. The estimated revenue raised for 2010 to 2019 is \$23.5 billion.

Other Changes

The Green Book details numerous other tax cuts and tax increases, as follows:

Additional Tax Cuts	\$ Billions
Tax Cuts for Families	(735)
Modify Federal Aviation Admin. Financing	(77)
Make Research and Development Credit Permanent	(74)
Extend Expiring Provisions Through 2010 (incl. NMTC)	(17)
Eliminate Capital Gains on Small Business Stock	(6)
Additional Tax Increases	\$ Billions
Increase Income Taxes on Upper Income Taxpayers	615
Limit Benefit of Itemized Deductions to 28% Tax Rate	267
Reform International Tax Provisions	210
Repeal Last-in First-out Inventory Accounting Method	61

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Increase Taxes on Oil & Gas	31
Change Estate and Gifts Tax Rules	24
Reinstate Superfund Taxes	17
Increase Taxes on Life Insurance Companies & Products	13
Expand Information Reporting	10
Repeal Lower of Cost or Market Inventory Accounting Method	6
Increase Taxes on Certain Financial Products	4
Require Information Reporting for All Rental Properties	3
Eliminate Advanced Earned Income Tax Credit	1

Responding quickly to the proposed tax increases on businesses, business began almost immediately to push back against the proposed increases. Those speaking out against the proposals included the U.S. Chamber of Commerce, the American Council of Life Insurers and the Business Roundtable, a coalition of U.S. corporate executives.

The May 11 release of the Treasury Department's Green Book not only provides the details that have been lacking in the Administration's many proposed revenue raisers, but it also provides tax experts with some answers and opportunities to study the technical aspects of the tax proposals. Of interest to the tax credit community are the expanded NOL carryback proposal, the codification of the Economic Substance Doctrine, and the taxation of carried interests as ordinary income. Community development professionals are comforted to see the extension of the New Markets Tax Credit through calendar year 2010. Now that we have seen additional details about the President's tax proposals, we need to monitor the activities of the House Ways and Means and the Senate Finance Committee to see which proposals gather steam and which start to collect dust. ❖

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