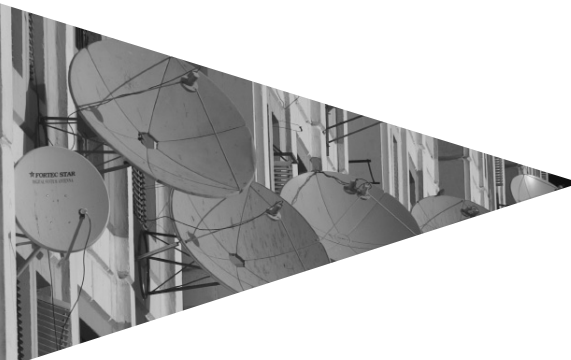


Washington Dispatch



In this issue...

Legislation

- 1 President Obama signs temporary payroll tax cut, unemployment extension

IRS news

- 2 Final regulations on foreign base company sales income branch rules released
- 3 IRS adopts final cost sharing regulations
- 3 Government issues final regulations on disregarded entities and conduit financing
- 5 New ID field added to certain foreign information returns will allow IRS to track more foreign entities
- 5 Stock price changes may affect USRPHC determinations
- 6 IRS issues proposed rules on basis reporting for debt instruments and options
- 7 IRS issues temporary and proposed regulations on Form 8938, Foreign Financial Asset Reporting under Section 6038D

Legislation

President Obama signs temporary payroll tax cut, unemployment extension

After weeks of negotiation and a nearly week-long impasse over the duration of the extension, the House and Senate both passed the Temporary Payroll Tax Cut Continuation Act of 2011 (H.R. 3765) on 23 December 2011, a bill to extend for two months the payroll tax holiday, expanded unemployment compensation, and Medicare physician payment rates.

The legislation, which passed by unanimous consent, was signed by President Obama the same day.

The measure extends the current payroll tax relief and the Medicare physician payment update through 29 February 2012. Given this was only a temporary extension, Congress will need to address the same issues again when it reconvenes in the New Year.

Note that the approximately \$30 billion cost of the bill is offset by an increase in the guarantee fees charged to mortgage lenders by Fannie Mae and Freddie Mac.

Congress did not address tax extenders legislation (including the subpart F active financing exception and CFC look through) before recessing for the holidays.

Joint congressional hearing addresses financial instruments

The Senate Finance Committee and House Ways and Means Committee held a joint hearing on 6 December on the tax treatment of financial instruments and financial products. The hearing included discussion of the taxation of derivatives, whether mark-to-market taxation is appropriate for individuals and some corporations, the possibility of changing the taxation of financial products without reforming the tax code, exchange-traded notes, and a financial transaction tax.

IRS News

Final regulations on foreign base company sales income branch rules released

The IRS on 16 December 2011 released final regulations (T.D. 9583) on the rules that apply to foreign base company sales income (FBCSI) when personal property sold by a controlled foreign corporation (CFC) is purchased, sold, manufactured, produced, constructed, grown or extracted by one or more of its branches. Specifically, these final regulations address the application of the “branch rules” when a CFC has multiple branches. With the issuance of these final regulations, the IRS and Treasury have also removed the temporary regulations that were released on 29 December 2008.

These final regulations adopt the provisions contained in the temporary regulations with the following minor modifications:

- ▶ The final regulations have eliminated the adverb “demonstrably” from Reg. Section 1.954-3(b)(1)(ii)(c)(3)(iii), where the regulations require a comparison of the “tested manufacturing location” against the “tested

sales location,” to prevent the use of such word from being misconstrued as a standard of proof.

- ▶ The final regulations have eliminated the confusion that seemed to exist regarding the rule on grouping of branches under Reg. Section 1.954-3T(b)(2)(ii)(a). The phrase, “the activities of,” has been added to the grouping rule, confirming that the purpose of the rule providing for the grouping of certain branches is only to determine whether the sales income of the sale or purchase branch (or remainder) is FBCSI (and does not change the quantum of income that is FBCSI).
- ▶ The final regulations have deleted Reg. Section 1.954-3(b)(2)(ii)(d), which provided that the manufacturing branch rules did not apply when FBCSI results from the application of the sale and purchase branch rules, as unnecessary given the rule under Reg. Section 1.954-3(b)(1)(ii)(c)(1), which provides that the manufacturing branch rules trump the sales branch rules when one or more sales branches are used in addition to a manufacturing branch.

The final regulations apply generally to tax years of a CFC beginning on or after 30 June 2009 and for tax years of US shareholders in which or with which such tax years of the CFC end. In addition, a taxpayer may choose to apply the final regulations to earlier open tax years that began before 1 July 2009, but only if the taxpayer and all members of the affiliated group apply the regulations in their entirety.

The bottom line is the final regulations do not change the rules contained in the 2008 temporary regulations in any substantial way.

In the preamble to the final regulations, the government acknowledges the need for continuing work in the FBCSI arena and states that they are considering whether to issue additional guidance. The issues specifically noted in the preamble as potential areas for future guidance are when a branch should be treated as a separate corporation and, interestingly, the scope and relationship between FBCSI and foreign base company services income. In addition to these two issues that were identified in the preamble, there are many other areas for which additional

Supercommittee member to introduce revenue neutral corporate reform bill

Senator Rob Portman (R-OH) -- a member of the supercommittee -- said in December he would soon introduce a corporate tax reform bill with a 25% tax rate and territorial treatment of foreign-source income, which the Congressional Joint Committee on Taxation scored as revenue neutral. The senator’s comments were made at the conservative Washington think tank, the American Enterprise Institute. A number of prior tax reform proposals have suggested that a top 28% federal corporate tax rate was possible by repealing all tax expenditures.

guidance could be helpful, including for example how a branch should be defined, how income should be allocated to perform the rate disparity test, and how losses and NOLs should be allocated for purposes of determining income, to name a few.

IRS adopts final cost sharing regulations

On 16 December 2011 the IRS released new final regulations under Section 482 (Reg. Section 1.482-7) governing cost sharing arrangements (CSAs). These regulations supersede temporary regulations (Reg. Section 1.482-7T or the 2009 temporary regulations) that were issued effective 5 January 2009 and were due to expire on 30 December 2011. In addition, on 19 December 2011, the IRS issued new temporary and proposed regulations that add or would add additional provisions to the final regulations. Generally, the final regulations closely follow the 2009 temporary regulations, although there a number of changes to the 2009 temporary rules. The preamble to the final regulations also describes certain additional guidance that may be issued in the future.

As compared to the 2009 temporary regulations, the most significant changes made by the three sets of regulations issued on 16 and 19 December are the addition of a number of new provisions and examples relating to the application of the Income Method. However, additional guidance on the use of

contingent payments that adjust in response to market success or failure and determination of reasonable anticipated benefit (RAB) share are also significant.

In addition, the preamble to the final regulations describes certain issues that the IRS declines to address. The preamble's discussion of these issues provides some insight into IRS thinking.

Note that the transition rules of the 2009 temporary regulations are unchanged. Consequently, CSAs that predate the 2009 temporary regulations and complied with the transition rules of the 2009 temporary regulations will also have complied with the transition rules of the final regulations.

Most of the changes represent technical amendments, particularly with respect to the determination of arm's length platform contribution transaction (PCT) payments. Of these, perhaps the most significant is identification of the "implied discount rate" in the new temporary regulations. This construct will probably be used frequently by the IRS in assessing the different discount rates used in the application of the Income Method to compare the results of the CSA and the licensing alternative.

From a broader perspective, the main implication of these regulations is that the IRS continues to believe that the transfer pricing methods first specified in the 2009 Temporary Regulations are likely to be the "best methods" for intangible assets or,

at least, technology intangibles that are subject to further development. Implied is the IRS's emphasis on transfer pricing compliance, particularly with respect to technology intangibles.

Government issues final regulations on disregarded entities and conduit financing

On 8 December 2011, Treasury and the IRS issued final regulations (T.D. 9562) under the conduit financing provisions of Section 7701(l) and Reg. Section 1.881-3 addressing financing arrangements that are effected through disregarded entities (DEs). The final regulations provide that a DE is a "person" for purposes of Reg. Section 1.881-3, and that transactions involving a DE will be taken into account in determining whether an entity is functioning as a conduit for purposes of avoiding Section 881 tax that would otherwise result if the conduit entity had not participated in the transaction.

The final regulations adopt without change the proposed regulations issued in 2008 and apply to payments made on or after 9 December 2011.

The final regulations do not address hybrid instruments (instruments that are treated as debt for foreign tax law purposes but not for US federal tax purposes), but the preamble states that Treasury and the IRS continue to study these and other equity instruments in the context of conduit financing arrangements.

When the proposed regulations on DEs and the conduit regulations were issued in 2008, Treasury and the IRS made clear that they viewed the proposed regulation as a clarification of the current rules rather than a change. Taxpayers have therefore been on notice that any structures involving DEs could come within the ambit of the conduit financing provisions.

Importantly, the preamble states that “no inference should be drawn from any provision of these final

regulations as to the treatment of financing transactions entered into with DEs before the effective date of these final regulations or involving hybrid instruments,” meaning that transactions involving payments to DEs prior to the date of the final regulations may be subject to recharacterization by the IRS under the Section 881 rules.

Note again that the final regulations apply to payments made on or after 9 December 2011; therefore taxpayers will need to consider the

impact of these regulations before making any year end payments. The preamble also states that Treasury and the IRS continue to study hybrid instruments and solicit comments on their treatment in financing transactions. Taxpayers may want to consider whether it would be beneficial to participate in the comment process as the government considers the appropriate treatment of hybrid instruments in the context of the conduit rules.

International tax news in the press

The annual IRS/George Washington University international tax conference took place in December in Washington, with government officials again offering some details of what guidance to expect in the near term. Government officials disclosed that regulations under Section 909 and an IRS Notice on Section 901(m) would be released in the coming weeks. This guidance will not be comprehensive. In addition, government officials said to expect interest allocation (Section 861) guidance in the near term.

According to press reports, IRS Commissioner Douglas Shulman said that proposed regulations relating to the Foreign Account Tax Compliance Act (FATCA) will be released early in 2011. (Temporary and proposed regulations under Section 6038(D), a FATCA provision, were issued on 14 December 2011). Treasury and IRS officials also disclosed that a large regulation project under Section 367(a)(5) would be released soon that, among other things, will clarify the Section 1248 consequences of a US parent selling shares in a CFC to a foreign purchaser. According to press reports, the government is not inclined to move in the direction of a full revamping of Section 1248, but rather addressing open issues in a piecemeal fashion in other regulatory projects.

Also coming out of the conference, the tax press reported that Michael Danilack, Deputy Commissioner (International), IRS Large Business and International Division, said the Service would soon withdraw the July 2010 directive it issued on technically defective gain recognition agreements (GRAs). The Directive generally provides that a taxpayer that timely filed a GRA with respect to an initial outbound transfer of stock or securities to a foreign corporation, but which was incomplete or inaccurate (e.g., in lieu of providing required information, indicating it is “available upon request”), may remedy the situation by filing an amended return, to which the complete and accurate GRA should be attached, without the need to obtain reasonable cause relief. The Directive also applies to missed or incomplete filings that may be required to be made during the five-year term of a timely-filed GRA (e.g., annual certifications).

Finally, a Treasury official disclosed that regulations under new Section 871(m), added by the *Hiring Incentives to Restore Employment Act* (HIRE Act) are imminent, if not before the end of this year then early in the new year. Section 871(m) requires withholding on certain dividend equivalent amounts.

New ID field added to certain foreign information returns will allow IRS to track more foreign entities

The IRS has provided advance notice, as required under Section 6038(a)(3), that it will require unique reference identification (URI) to identify all foreign entities that file Forms 5471, 8858, and 8865, if the entities do not already have employer identification numbers (EINs). The purpose of the URI is to “uniquely identify the foreign corporation in order to keep track of the foreign corporation from tax year to tax year.” The use of a URI will be required on forms for tax years of foreign entities beginning in 2012 and optional for tax years of foreign entities beginning in 2011.

Section 6038(a)(1) requires any US person who controls a foreign business entity to provide certain information to the IRS. However, Section 6038(a)(3) requires that the Service prescribe the furnishing of such information on or before the first day of the annual accounting period to which the requirement relates.

This new reporting is part of the IRS's continuing efforts to enhance international information reporting requirements to improve its compliance risk assessment capabilities. The new requirement will allow the Service to better track entities, including formation of new entities, ownership changes, and

dispositions. The Service will also likely use this as an additional risk assessment tool for audit selection and compliance actions.

The draft instructions included in the IRS posting include a reminder of potential penalties. Taxpayers will also want to consider whether failure to provide an EIN or URI could result in the possible suspension of statute of limitations under Section 6501(c) (8).

Affected taxpayers will want to determine which foreign corporations, disregarded entities, and partnerships will be subject to

the URI requirement and the method they will use to create, if needed, and assign the URIs. Additionally, taxpayers should consider any programming and recordkeeping changes that need to be made to comply with the new reporting requirement, as well as any tax return preparation process changes.

Stock price changes may affect USRPHC determinations

The significant changes in stock trading prices experienced over the past five years (in particular between 2008 and 2010) may have caused dramatic fluctuations in the

Get the world – to go Now getting tax rates is easier than ordering take out

You can now access corporate income tax rates of over 60 countries whenever and wherever using your mobile device. Rates are updated quarterly.

Type into your
mobile web browser:
www.ey.mobi/ITS/rates



enterprise value of publicly traded corporations during this period. Recent market experience has shown that these enterprise value fluctuations may lead to unexpected results when a domestic corporation is asked to certify that it has not been a United States real property holding corporation (USRPHC) prior to the sale of its stock by a foreign person, as required by the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) rules.

Many corporations do not realize they must provide a certificate of non-USRPHC status at the request of a foreign seller until a deal is near closing, and may then incur considerable time and expense in making the USRPHC determination in a compressed amount of time.

Corporations with meaningful amounts of real property interests (including leasehold interests, tenant improvements or other types of assets that the FIRPTA rules consider real property interests even though they are not "real property" in the traditional sense) should carefully examine their particular facts and circumstances prior to drawing a conclusion as to their USRPHC status. In particular, they should proactively review whether fluctuations in their enterprise value based upon the trading price of their stock over the past five years may have caused them to be considered a USRPHC prior to issuing a non-USRPHC certificate, which is signed under penalties of perjury.

Similarly, buyers and foreign sellers of stock should carefully consider whether a target may be a USRPHC far enough in advance of a sale to allow adequate time for the corporation to review its particular facts and circumstances during the preceding five years, so that it may issue the non-USRPHC certificate if appropriate and thereby avoid the 10% withholding tax that would otherwise apply.

IRS issues proposed rules on basis reporting for debt instruments and options

The IRS in late November 2011 issued proposed regulations addressing the third phase of the cost basis regime (REG-102988-11) under Sections 6045, 6045A, and 6045B. In these regulations, the Service addresses basis reporting for debt instruments and options, which will be required when such specified securities are acquired after 2012 and subsequently sold, redeemed or (in the case of options) lapse, are exercised (in certain cases), or are otherwise closed out.

The proposed regulations do not require reporting on obligations governed by Section 1272(a)(6), *i.e.*, REMIC regular interests and other asset-backed obligations, the payments on which can be accelerated if the underlying obligations prepay. Similarly, pools of debt instruments, such as mortgage pass-through certificates, will be outside the scope of basis reporting for now.

Reporting basis for debt instruments is complex because a holder is allowed to make a number of choices about how to account for instruments issued or acquired at a discount or premium, and these elections affect basis. The proposed regulations provide that a holder will be deemed to have made certain elections for basis reporting purposes only. Holders will still be able to make their own elections for substantive tax purposes, but if they make different elections than those that are assumed for purposes of basis reporting, they will be required to reconcile their actual basis with the basis reported on their Form 1099-B.

Historically, options have been outside the scope of Form 1099-B reporting altogether. However, they will be subject to Form 1099-B reporting (including basis reporting), beginning in 2013. The proposed regulations contain rules for reporting basis with respect to options on securities that are themselves subject to basis reporting, *e.g.*, stocks and debt instruments. The proposed regulations generally are consistent with the substantive tax accounting for options, except for listed options on nonequity securities and on broad-based stock indices.

The proposed regulations also make conforming changes to the rules governing statements under Section 6045A when a security subject to

basis reporting is transferred from one broker to another (transfer statements), and provide rules for when the writer of an option or the clearinghouse must report changes to the terms of the option due to an organizational event with respect to the underlying security under Section 6045B (issuer statements).

Finally, the proposed regulations would provide that in all cases the reported gross proceeds on a sale must be reduced by transfer taxes and commissions (previously this was optional), and amend existing regulations that will require a broker transferring a security to reflect all necessary adjustments for organizational actions taken through and on the transfer settlement date when completing a transfer statement. The current regulation excludes adjustments by the delivering broker for organizational actions taken on the transfer settlement date.

The regulations are proposed to be effective for securities acquired after 2012, which does not leave much time for implementation. Those institutions that are affected need to begin preparations quickly.

IRS issues temporary and proposed regulations on Form 8938, Foreign Financial Asset Reporting under Section 6038D

The government on 14 December 2011 issued temporary (T.D. 9567) and proposed (REG-130302-10) regulations under the foreign financial asset reporting rules of Section 6038D. These rules generally require US *individuals* to report ownership of a broad array of foreign financial assets, including foreign financial accounts, foreign securities, interests in foreign entities and trusts, and interests in foreign pension plans. Although the statute gives the government power to extend reporting to certain US domestic entities, the rules on this are only proposed, and are not proposed to apply for tax years beginning before 2012.

Notice 2011-55 suspended the obligation to file under Section 6038D until Form 8938, "Statement of Foreign Financial Assets," was issued. A final version of Form 8938 was released on 17 December 2011 and final instructions were released on 19 December 2011.

Although Section 6038D reporting is in addition to reporting under the foreign bank account rules, the temporary regulations contain a number of provisions to eliminate reporting on assets that are also reported on certain other IRS forms, such as Forms 8621 (passive foreign investment companies), and raise the amount of reportable assets that one must own before one must report above the statutory minimum. A special higher reporting threshold applies to individuals living abroad.

The temporary regulations (applying to specified individuals) apply to tax years ending after 19 December 2011. Taxpayers may elect to apply the rules of this section to tax years ending before 19 December 2011. An individual's obligation to file the Form 8938 in 2011 is deferred to 2012 if the individual:

- ▶ Had a tax year that began after 18 March 2010;
- ▶ Was required to file Form 8938; and
- ▶ Filed an annual return before Form 8938 was released.

Ernst & Young LLP, International Tax Services, Washington, DC

▶ Margie Rollinson	+1 202 327 5757
Sal Vaudo	+1 617 375 8333
▶ Robert Ackerman	+1 202 327 5944
▶ Barbara Angus	+1 202 327 5824
▶ Stephen Bates	+1 415 894 8190
▶ David Canale	+1 202 327 7653
▶ Doug Chestnut	+1 202 327 5780
▶ Ken Christman	+1 2-2 327 8766
▶ David Golden	+1 202 327 6526
▶ Liz Hale	+1 202 327 8070
▶ Lilo Hester	+1 202 327 5764
▶ Stephen Jackson	+1 212 773 8555
▶ Karen Kirwan	+1 202 327 8731
▶ Kyle Klein	+1 202 327 8843
▶ Richard Larkins	+1 202 327 7808
▶ David Levere	+1 212 773 4610
▶ Dick McAlonan	+1 202 327 6025
▶ Stephen Meadows	+1 202 327 6020
▶ Alan Munro	+1 202 327 7773
▶ Jose Murillo	+1 202 327 6044
▶ Peg O'Connor	+1 202 327 6229
▶ Chris Ocasal	+1 202 327 6868
▶ Al Paul	+1 202 327 7476
▶ John Turro	+1 202 327 8019
▶ Tim Wichman	+1 312 879 2282
▶ Steven Wrappe	+1 202 327 5956
▶ Denen Boyce	+1 202 327 5602
▶ Tom Coony	+1 202 327 5658
▶ Norman Hannawa	+1 202 327 6250
▶ Julio Jimenez	+1 212 773 5297
▶ Petya Kirilova	+1 202 327 6075
▶ Tammy LeGrys	+1 202 327 7757
▶ Katherine Loda	+1 212 773 6634
▶ John Morris	+1 202 327 8026
▶ Jasper Nzedu	+1 202 327 6203
▶ Ben Orenstein	+1 212 773 4485
▶ Karen Petrosino	+1 212 773 0375
▶ Julia Tonkovich	+1 202 327 8801
▶ fax number	+1 202 327 6721

International Tax Services

- ▶ Global ITS, **Jim Tobin**, *New York*
- ▶ ITS Director, Americas, **Jeffrey Michalak**, *Detroit*
- ▶ National Director of ITS Technical Services, **Margie Rollinson**, *Washington*
- ▶ ITS Director of National Washington, DC, **Sal Vaudo**, *Washington*

- ▶ Northeast
Craig Hillier, *Boston*
- ▶ East Central
Johnny Lindroos, *McLean, VA*
- ▶ FSO
Phil Green, *New York*
- ▶ Midwest
Simon Moore, *Chicago*
- ▶ Southeast
Scott Shell, *Charlotte, NC*
- ▶ Southwest
Paul Palmer, *Houston*

- ▶ West
Julie Wooldridge, *Irvine, CA*
- ▶ Canada - Ernst & Young LLP (Canada)
George Guedikian, *Toronto*
- ▶ Israel - Kost Forer Gabbay & Kasierer
Sharon Shulman, *Tel Aviv*
- ▶ Mexico and Central America - Mancera, S.C.
Koen Van 't Hek, *Mexico City*
- ▶ South America
Alberto Lopez, *New York*

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 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.

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. For more information about our organization, please visit www.ey.com.

International Tax Services

About Ernst & Young's International Tax Services practices

Our dedicated international tax professionals assist our clients with their cross-border tax structuring, planning, reporting and risk management. We work with you to build proactive and truly integrated global tax strategies that address the tax risks of today's businesses and achieve sustainable growth. It's how Ernst & Young makes a difference.

The Washington Dispatch is a monthly communication prepared by Ernst & Young LLP's Washington International Tax Services summarizing recent developments and "inside-the-beltway" news pertinent to multinational companies. For additional information, please contact your local international Tax professional.

ITS Washington, DC
Margie Rollinson

www.ey.com

© 2011 Ernst & Young LLP.
All Rights Reserved.

SCORE no. CM2642

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 EYGM Limited 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.