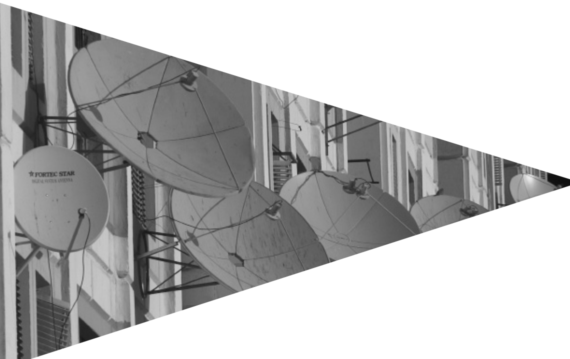
May 2011, Volume 15, Issue 5

Washington Dispatch



In this issue...

Legislation
1 Deficit, debt and tax reform dominate debate

IRS news
3 IRS final regulations address Subpart F treatment of aircraft and vessel leasing income under Sections 367, 954 and 956
3 New withholding from government entities to contractors delayed

Courts
4 Fifth Circuit affirms Tax Court decision in *Container Corp. v. Commissioner*

OECD
4 OECD proposes clarifications to meaning of beneficial owner in OECD Model Tax Treaty

Legislation

Deficit, debt and tax reform dominate debate

The US government's finances are dominating public discourse in Washington, with both the Obama Administration and Congress positioning themselves for upcoming negotiations over the FY 2012 federal budget, the deficit and the debt, and the possibility of comprehensive tax reform.

The most pressing concern facing the government is the need to raise the federal debt limit, currently set at $14.3 trillion. The long-awaited statutory debt ceiling was finally reached on 16 May. Until very recently, the assumption was that there were mechanisms available to Treasury to allow the United States to fulfill its financial obligations until sometime in early July.

That looming deadline has been extended by Treasury Secretary Timothy Geithner, who in a letter dated 2 May said Treasury can employ "extraordinary measures" that would allow the movement to meet its financial obligations until roughly 2 August. This effectively has provided more time for Congress to debate the parameters of a political deal that will allow Congress to raise the debt limit. Republicans (and some Democrats) have made clear that a package of specific, binding deficit reduction plans will be tied to any debt limit increase.

There was some speculation that the so-called Gang of Six would issue their bipartisan plan for deficit reduction in early May, but that failed to materialize. The group – originally made up of Republican Sens. Saxby Chambliss (R-GA), Tom Coburn (R-OK), and Mike Crapo (R-ID), and Democrats Kent Conrad (D-ND), Dick Durbin (D-IL), and Mark Warner (D-VA) – has been meeting regularly since last December. Senator Coburn has since dropped out of the Gang of Six and it is now unclear when their deficit plan will be released.

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Another bipartisan deficit reduction group, established by President Obama and headed by Vice President Joe Biden, held their first meeting on 5 May. Members appointed to the group are Sen. Max Baucus (D-MT), Rep. Eric Cantor (R-VA), Rep. James Clyburn (D-SC), Sen. Daniel Inouye (D-HI), Sen. Jon Kyl (R-AZ), and Rep. Chris Van Hollen (D-MD).

Meanwhile, both the House Ways and Means Committee and Senate Finance Committee continued to hold hearings on the subject of comprehensive tax reform.

On the Senate side, the Finance Committee held two hearings in early May on tax reform and "budget enforcement mechanisms." The tax reform hearing (3 May) focused on the distribution of tax burdens and benefits in the tax code, and also included a discussion of international tax reform. Sen. Ron Wyden (D-OR), who co-sponsored a bill (S. 727) that would eliminate deferral, said during the hearing that he was open to talking about a territorial tax system, but could not figure out a way to include such a system in S. 727 without encountering "the gaming problems with transfer pricing."

The next day (4 May) the Finance Committee held a hearing on the idea of imposing automatic cuts in spending or tax expenditures, at which Committee Chairman Baucus said he agreed that the corporate tax rate was too high, but said: "The problem with that [reducing the tax rate] is all tax expenditures would have to be repealed, including deferral and the R&D tax credit. It obviously is something that does not make sense." Chairman Baucus went on to say that there is a need to find a system to lower the tax rate, and one possible solution is to tax pass-through entities as corporations if they earn above a certain level of income.

In the House, Ways and Means Committee Chairman Dave Camp, (R-MI) was quoted as saying he would welcome a tax reform discussion that focuses on lowering tax rates by reducing tax expenditures, similar to the approach taken by President Obama's deficit commission, the National Commission on Fiscal Responsibility and Reform.

The Ways and Means Committee also continued its series of hearings on the need for comprehensive US tax reform. Four CFOs from major US multinationals testified on 12 May in favor of a lower US corporate tax rate and switch to a territorial tax system. Under questioning by Rep. Lloyd Doggett (D-TX), the CFOs also came out against a stand-alone repatriation holiday (outside of the context of comprehensive tax reform) to allow companies to bring foreign earnings back to the United States at a reduced tax rate. (A stand-alone repatriation bill was introduced in Congress in mid-May; more on that below). Some of the CFOs testified that a stand-alone repatriation proposal could be a distraction from the goal of comprehensive tax reform.

In his opening statement at the 12 May hearing, Chairman Camp noted that a future committee hearing will examine the US tax treatment of inbound investments by companies headquartered abroad.

As mentioned above, a repatriation proposal (H.R. 1834) was introduced by Rep. Kevin Brady (R-TX) and Jim Matheson (D-UT) on 11 May that would allow US multinationals to repatriate foreign earnings at a 5.25% rate, with a penalty mechanism to prevent companies taking advantage of the special relief from subsequently reducing employment.

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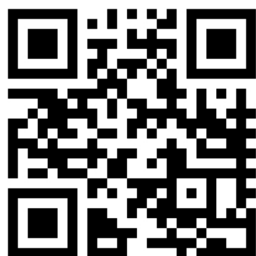

Referring to H.R. 1834 at the 12 May Ways and Means Committee hearing, Rep. Doggett countered by releasing a Joint Committee on Taxation staff estimate showing a general repatriation proposal (an 85% dividend received deduction) would cost the US fisc roughly $79 billion over 10 years. An important part of the JCT estimate, which was not based on H.R. 1834, was the JCT's assumption that a second repatriation holiday would encourage firms to defer more income in anticipation of future holidays. In particular, the JCT emphasized that a revenue estimate for repatriation as part of a permanent territorial dividend exemption proposal would be different than a stand-alone second repatriation holiday, which "creates a system within a system, contributing to the overall negative revenue results."

The Obama Administration has repeatedly said it opposes any stand-alone repatriation proposal.

On the broader issue of comprehensive US tax reform, House Speaker John Boehner (R-OH) said that lowering the corporate tax rate is "critically important" to job growth and indicated that eliminating certain existing tax expenditures may be necessary to pay for that reduction. Speaker Boehner said he expected Congress to take up a corporate tax reform bill in the next two years and that lawmakers should be "looking seriously at a territorial tax code." He also said corporate tax reform did not have to move with individual reform, though the flow-through entity issue will need to be addressed.

His Republican counterpart in the Senate, Minority Leader Mitch McConnell (R-KY) meanwhile ruled out the possibility of reaching agreement on comprehensive tax reform before Congress' August recess. "You can't do tax reform in two months," Sen. McConnell said.

IRS news

IRS final regulations address Subpart F treatment of aircraft and vessel leasing income under Sections 367, 954 and 956

The IRS on 5 May 2011 issued final regulations on the treatment under Subpart F and Section 367 of leasing aircraft or vessels in foreign commerce. These regulations reflect changes made to the Subpart F treatment of such leases by the *American Jobs Creation Act of 2004*.

The final regulations adopt with certain modifications the temporary and proposed regulations issued in July 2008.

The final regulations clarify that under the safe harbor for excluding income from leasing aircraft or vessels in foreign commerce from Subpart F because the lessor performs sufficient marketing/remarketing activities, qualifying marketing/remarketing activities include activities for purposes of re-leasing or selling the leased property. In addition, it is irrelevant whether the lease is treated as an operating lease or finance lease for financial accounting purposes, so long as it is treated as a lease for US Federal income tax purposes.

The final rules further clarify that an aircraft or vessel is "leased in foreign commerce" for this purpose if it is used in foreign commerce (*i.e.*, used for the transportation of passengers and property between a US port/airport and a non-US port/airport, or between two non-US ports/airports), and is used predominantly outside the United States.

Finally, the regulations provide that a leased aircraft or vessel that comes to the United States is exempt from being treated as an "investment in United States property" for purposes of Section 956 only if the aircraft or vessel is leased in foreign commerce and the rents received are excluded from Subpart F income under the rules discussed above.

Overall, the final regulations represent a set of taxpayer-favorable clarifications. As the preamble states, the government will continue to study and request comments on how to determine whether an aircraft or vessel is used predominantly outside the United States during a particular month for purposes of calculating depreciation recapture under Section 367. Until such guidance is issued, taxpayers may continue to use any reasonable method to make this determination.

New withholding from government entities to contractors delayed

The IRS issued final regulations (T.D. 9524) that would delay the implementation of a new 3-percent withholding requirement on payments from government entities to contractors until 1 January 2013,

and exempt any payments of less than $10,000. The regulations are effective as of 9 May and reflect changes in the law made by the *Tax Increase Prevention and Reconciliation Act of 2005* that require federal, state, and local government entities to withhold and report income tax when making payments to persons providing goods or services.

Subject to certain conditions, certain payees are exempt from withholding, including nonresident alien (NRA) individuals and foreign corporations that receive certain types of payments (and partnerships that receive certain types of payments and that are 80 percent or more owned by NRA individuals and foreign corporations). Withholding does not apply to these persons if the payment is derived from sources outside the United States, as determined under Sections 861, 862, 863, and 865, and is not effectively connected income within the United States by the NRA individual or foreign corporation.

Courts

Fifth Circuit affirms Tax Court decision in *Container Corp. v. Commissioner*

The Fifth Circuit Court of Appeals in *Container Corp v. Commissioner* affirmed a decision of the Tax Court that the source of a guarantee fee should be determined by analogy to the rules for determining the source of fees for services. Accordingly, guarantee fees paid by a US subsidiary to its Mexican parent were Mexican-source income under the facts of the case, and therefore not subject to withholding under Section 1442.

The ruling may have limited weight, however. The opinion is unpublished, and so is not binding precedent (although it may be cited) even in the Fifth Circuit. Further, there is contrary authority in the Court of Federal Claims. Finally, in response to the Tax Court case, Congress enacted Sections 861(a)(9) and 862(a)(9), which provide that amounts received directly or indirectly for guarantees of indebtedness of the payer issued after 27 September 2010 will be sourced like interest and, as a result, if paid by a US corporation to a foreign person will be US-source income, and subject to withholding under Section 1442 unless a tax treaty provides otherwise.

Nonetheless, the decision of the Fifth Circuit leaves the opinion of the Tax Court in place, and that case can be used as precedent for source fees with respect to guarantees issued on or before 27 September 2010. But it is not clear whether the IRS will continue to litigate the issue, or whether courts, especially outside of the Fifth Circuit, will follow this case.

Although this case may be welcome news for some taxpayers, especially those located in the Fifth Circuit, it is of no value for future planning, and its relevance for previous transactions is not entirely free from doubt. However, taxpayers may wish to consider the case when faced with the question of sourcing income for which there is no statutory sourcing rule.

OECD

OECD proposes clarifications to meaning of beneficial owner in OECD Model Tax Treaty

On 29 April 2011, the OECD's Centre for Tax Policy and Administration released a public discussion draft of proposed changes to the Commentary on Articles 10, 11 and 12 of the OECD Model Tax Convention, focusing on the clarification of the meaning of the term "beneficial owner."

The concept of beneficial owner found in Articles 10, 11 and 12 of the OECD Model Tax Convention is used to determine whether the recipient of a payment is entitled to treaty benefits with respect to the payment (as opposed to being a mere agent, nominee, etc.). The concept has given rise to different interpretations by courts and tax administrations.

Among other things, the Discussion Draft proposes to clarify the concept of a "beneficial owner" in the context of the Model Treaty by adding identical language to the Model Treaty's commentary on Articles 10, 11, and 12. Under the proposed clarification, it is explicit that the term "beneficial owner," as used in the Model Treaty is not intended to be interpreted to refer to any technical meaning that it could have under the domestic law of a specific country. Instead, it should be understood in its treaty context (namely, avoiding double taxation and prevention of fiscal evasion and avoidance) and in relation to the words "paid … to a resident."

The Discussion Draft's clarification further provides that the recipient of a dividend, interest, or royalty payment is the "beneficial owner" of the subject payment if he has the full right to use and enjoy the dividend, interest, or royalty unconstrained by a contractual or legal obligation to pass the payment received to another person. The proposed commentary notes that such an obligation will normally derive from relevant legal documents, but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the payment.

The Discussion Draft also clarifies that the mere fact that the recipient of a payment is considered to be the beneficial owner of that payment does not mean that the recipient is entitled to treaty benefits with respect to the payment. Rather, the proposed language explicitly states that treaty benefits should not be granted in cases of abuse and refers to other methods of combating treaty-shopping situations, including specific treaty anti-abuse provisions, general anti-abuse rules and substance-over-form or economic substance approaches.

The Draft Discussion's proposed clarification represents a step towards achieving an international consensus on the scope and meaning of the term beneficial owner. This step appears to be in tacit agreement with the UK Court of Appeal's decision in *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA* that the term should be interpreted as a global concept and "be given an international fiscal meaning not derived from the domestic laws of contracting States." If the proposed clarification is adopted, the confusion that has arisen in particular due to different interpretations given by some common-law jurisdictions where the term beneficial owner has traditionally been narrowly interpreted should be greatly diminished.

Given the impact these changes could have with respect to treaty interpretations by member countries of the OECD, taxpayers should closely review the Discussion Draft and consider whether it would be appropriate to provide comments on the proposed additions.

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