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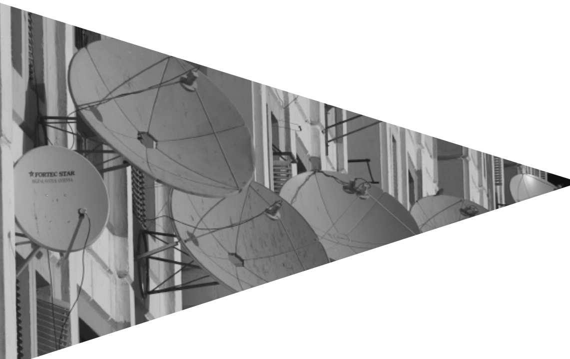

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Legislation

Supercommittee fails deficit agreement deadline

The Joint Select Committee on Deficit Reduction, aka supercommittee, failed to meet its deadline to come up with a deficit reduction package that would bring about $1.2 trillion in savings over ten years. Although the Budget Control Act of 2011 stipulated that the supercommittee had to vote on a plan by 23 November 2011, Republicans and Democrats on the committee could not reach consensus on taxes and cuts in spending.

More specifically, the Budget Control Act required that the supercommittee vote by 23 November on a report that included a detailed statement of findings, conclusions and recommendations of the committee, including the Congressional Budget Office's estimate of the recommendations. The supercommittee also was required to come up with legislative language to carry out its recommendations.

What was lost by missing the 23 November deadline were certain procedural safeguards that would have offered a less burdensome administrative process that would have increased the likelihood of the legislation being enacted, e.g., no amendments to the legislation or filibusters.

According to the Budget Control Act, if the supercommittee actions do not result in a bill being enacted by 15 January 2012, or if legislation produced by the supercommittee process is enacted that reduces the deficit by less than $1.2 trillion over 10 years, across-the-board sequestration, split between domestic spending (with certain limitations) and defense spending for FY 2013 and later, is triggered. The automatic spending cuts would take effect beginning 2 January 2013.

Given this timeframe, Congress still has considerable time to craft a legislative solution prior to the effective date of the sequestration (January 2013), albeit during an election year.

As the deadline neared, there was some hope that an agreement could be reached. Several Republicans on the supercommittee crossed the political rubicon and offered up a proposal for $250 billion in revenue increases

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that would have been coupled with reductions in the top individual tax rate to 28 percent and the corporate rate to 25 percent. Democrats on the supercommittee assailed the plan as inadequate, however.

Meanwhile, a bipartisan group of approximately 150 congressional legislators at the 12th hour urged the supercommittee to go far beyond the $1.2 trillion in savings needed to avoid sequestration. The so-called "Go Big" Coalition — including Republican members who have signed a no tax increase pledge — pushed for a grand deal that would cut $4 trillion from the budget over 10 years.

More details emerge on Ways and Means territorial tax proposal

Ernst & Young LLP has learned more about Ways and Means Committee Chairman Dave Camp's (R-MI) proposal to move the United States to a territorial tax system. Sean Hailey, Tax Advisor to the W&M Committee, participated in an EY hosted webcast on 9 November, joining an EY panel that included co-director of National Tax Michael Mundaca, a former Treasury Assistant Secretary for Tax Policy. Barbara Angus, ITS partner and former Treasury International Tax Counsel, acted as moderator for the panel discussion.

Hailey addressed the thorny issue of transition rules during the webcast, including the proposed rule that would require a 10% US shareholder of a CFC or 10/50 company to treat its pro rata share of accumulated deferred earnings as the CFC's or 10/50 company's subpart F income in the last year starting before the adoption of the new territorial system.

Former Treasury official Jose Murillo, now an EY partner, highlighted that because subpart F income as calculated under the transition rule would simply be an entity's deferred foreign income determined as of the end of that tax year, in some cases the amount could be over-inclusive. "That could include the deferred earnings of 10/50 companies that existed before the US shareholder acquired its interest," he said. Murillo asked whether the committee might scale the rule back to include only deferred earnings accumulated while under the US shareholder's ownership.

Hailey said the territorial proposal has not yet considered numerous transitional issues, including overall foreign losses and overall domestic losses, foreign tax carryforwards, dual consolidated losses, and gain recognition agreements, among others. Hailey reiterated, however, that while "we're going to need help on these transition rules, right now we want to make sure we have the base structure correct before we start moving into more details."

Addressing thin capitalization in the territorial plan, Hailey said the drafters looked at other countries' territorial systems, with the idea that US thin capitalization would mesh with what other countries have done to prevent base erosion in this area.

The panel also touched on the three options in the plan that address base erosion: (1) President Obama's excess returns proposal, (2) a variation on the "low effective rate" test used by some US trading partners, and (3) a lower tax rate for foreign intangible income, but coupled with subpart F treatment if the CFC's foreign intangible income if taxed at a rate of less than 13.8%.

Hailey noted the Obama Administration's excess returns proposal was already on the table, so it made sense to include it as one of the proposals. Regarding the second option, Hailey said on the EY webcast that it was based on the committee's discussions with foreign officials and taxpayers. As for the third option, Hailey said it originated from earlier Congressional hearings on transfer pricing as well as concerns raised by the Joint Committee on Taxation with regard to base erosion. To address taxpayer concerns that US multinational corporations owning intangible property in the US would be required to pay more US tax than US multinationals owning intangible property in foreign jurisdictions under a new territorial system, the committee proposed a modified "patent box" option with a broad definition of intangible income coupled with a low effective tax rate. The Committee's modified "patent box" proposal, however, focuses more heavily on preventing

erosion of the US tax base, rather than increasing domestic activities, such as R&D and other forms of innovation. The latter goal is the focus of the "patent box" regimes implemented by our European trading partners.

Hailey told the EY audience that the three anti-abuse options should be viewed as suggestions and that if there are better options, the committee was interested in learning about them. Hailey ended the panel discussion by stating that the Ways and Means proposal is only a discussion draft and the committee is looking forward to hearing taxpayer comments and hopefully building on the draft.

House Ways and Means subcommittee holds hearing on territorial tax proposal

The House Ways and Means Subcommittee on Select Revenue Measures on 17 November held a hearing on the territorial tax proposal discussion draft released by W&M Chairman Dave Camp (R-MI) on 26 October 2011. The hearing included in-depth discussion of the anti-base erosion options presented in the discussion draft and other proposals that could be pursued, as well as the issue of expense allocation. Democratic members largely focused their attention on the feasibility of paying for the 25% corporate tax rate assumed in the discussion draft.

IRS news

Proposed regulations address taxation of foreign government income under Section 892

The IRS on 2 November 2011 issued proposed regulations (REG-146537-06) that provide guidance on the taxation of income of foreign governments from investments in the United States under Section 892. The proposed regulations in part modify temporary and proposed regulations that were issued in June 1988.

Section 892 provides that US source income (e.g., dividends, interest, capital gains) received by foreign governments (including their controlled entities) from investments in the United States in stock, bonds, or other domestic securities, or financial instruments held in the execution of governmental financial or monetary policy, is generally not subject to US tax. This exemption for qualified investments under Section 892 does not apply, however, to income (1) derived from the conduct of any commercial activity; (2) received from or by a controlled commercial entity; or (3) derived from the disposition of any interest in a controlled commercial entity.

The proposed regulations contain generally positive modifications to the current Section 892 rules, including:

- An exception to the "all or nothing" rule for inadvertent commercial activity;
- Annual determination of controlled commercial entity status;
- Guidance regarding what commercial activities will not include;
- Investing in financial instruments (including derivatives), regardless of whether they are held in the execution of governmental financial or monetary policy;
- Disposing of a US real property interest; or
- Holding certain limited partnership interests or being a partner in a partnership that is engaged in trading activity for its own account.

The preamble to the proposed regulations states that the regulations are not effective until they are published as final regulations in the Federal Register, but taxpayers may rely on the proposed regulations until final regulations are issued.

While the proposed regulations may not address all the concerns taxpayers have expressed about the 1988 temporary regulations during the past 20 years, they provide significant relief with respect to

the "all or nothing" rule, which for many, especially for sovereign wealth funds, was the chief objection to the earlier guidance. The revised rules for attribution of partnership activities are also welcome in that they will allow foreign government-controlled entities (particularly private equity funds and other investment partnerships) to participate in a broader range of investment vehicles with less risk of tainting the 892 status of the controlled entity.

Proposed regs clarify rules for controlling domestic shareholders to adopt, change accounting method or tax year on behalf of foreign corporation

On 4 November 2011, the US government released proposed regulations (REG-114749-09) and withdrew proposed regulations issued in 1992. The new proposed regulations would clarify the rules for controlling domestic shareholders to adopt or change a method of accounting or tax year on behalf of a foreign corporation under Reg. Section 1.964-1. The proposed regulations also provide clarification of the required book-to-tax adjustments required under Reg. Section 1.964-1, including those for depreciation and amortization, and provide useful examples illustrating the application of Reg. Section 1.964-1(a) and (c). Finally, the proposed regulations provide rules regarding method changes initiated by the IRS on audit.

The proposed regulations will apply to the computation of the earnings and profits of foreign corporations in tax years of foreign corporations beginning on or after the date the proposed regulations are finalized, and tax years of shareholders with or within which such tax years of the foreign corporations end.

IRS issues UTP guidance and procedures to field employees and managers

On 1 November 2011, LB&I Commissioner Heather Maloy released an internal memorandum entitled, "UTP Guidance and Procedures for the Field." The internal guidance is very specific on what agents can and cannot do in the context of Schedule UTP, reinforces the Quality Examination Process (QEP) and the tax accrual workpaper policy of restraint, and provides three different scenarios related to the situations that may be encountered with specific guidance. It also requires agent to receive training on tax reserves and the procedures related to the examination of positions reported on the Schedule UTP before using any information reported in the schedule.

Key points and themes in the new memorandum include:

- An issue identified on the Schedule UTP is not a "mandatory" examination issue, but the examiner should exercise judgment, after discussions with the taxpayer and conducting a risk assessment, in determining whether or not the issue should be further examined.
- The examiner should determine whether to raise an issue disclosed on the Schedule UTP in a prior year. Generally, if the prior year's examination had reached the resolution phase of the examination, it would not be raised, and the case would be closed as planned. If the return was not under examination and

EC begins process of addressing double taxation

The European Commission on 11 November 2011 released a communication, Double Taxation in the Single Market, as a first step in addressing the problems of double taxation. The Commission also issued a proposal for a recast of the EU Interest and Royalties Directive that would significantly expand the scope of the Directive. The Commission will submit the Communication on Double Taxation to the European Parliament, Council and European Economic and Social Committee for discussion, and the Interest and Royalty Directive proposal to the European Council and the European Parliament.

the examiner decided to request the prior year return to examine the issue, approval from the team manager would be required. If the prior year was under examination but in the planning or execution phase of the examination, team manager approval would be required before pursuing the issue disclosed in the subsequent year.

- The tax accrual workpaper policy of restraint shows up in the guidance regarding what an examiner may or may not request. The guidance tries to provide a clear line of demarcation; the examiner may ask the taxpayer for relevant facts and information about the identity of the tax issue. However, the examiner cannot ask about the rationale for why there is an uncertainty, an analysis of support for or against the tax position, or information regarding hazards of the position. Under the modified policy of restraint, copies of workpapers used to prepare the Schedule UTP, tax accrual workpapers, or privileged documents may not be requested.
- The engagement of team managers and territory managers is mandatory for the oversight of the use of the Schedule UTP and in discussions with teams before meetings begin with the taxpayer. Territory managers may be involved in taxpayer discussions depending on the facts and circumstances of each case.

The guidance makes it clear that examination teams should not be asking taxpayers about the make-up of a taxpayer's reserves. The guidance reinforces the Service's intent to retain the modified tax accrual workpaper policy of restraint. As such, taxpayers should ensure that all questions and IDRs from the Service are in line with that policy of restraint. Because of the diversity of experience among the LB&I employee base and some confusion that may arise in communications, understanding the guidelines and what may be an inappropriate request will be important.

The guidance also makes clear that the fact that an issue appears on the schedule does not mean that the issue automatically must be examined. Rather, the normal risk analysis and procedures under the QEP for selecting an issue must be followed.

Finally, with the appropriate risk assessment and management approval, a Schedule UTP disclosure item could result in an audit of a prior tax year. Taxpayers therefore should be prepared for potential audit scrutiny.

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