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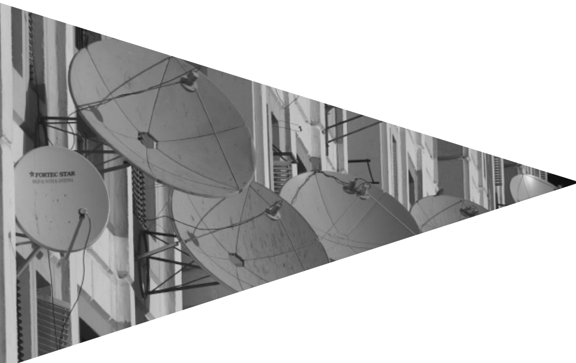

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Legislation

Debt debate closes in on 2 August deadline

The ongoing US debt negotiation reached crisis proportions at the end of July as Congress failed to reach a compromise on legislation that would raise the debt limit before the 2 August deadline when the federal government runs out of money.

As we go to press (29 July), House speaker John Boehner (R-OH) and Senate Majority Leader Harry Reid (D-NV) have put forward two different plans that would increase the federal debt ceiling and reduce expected federal spending over 10 years. Speaker Boehner's proposal would allow for the debt ceiling to be increased by up to $2.5 trillion in two separate steps, and Senate Leader Reid's plan would permit an immediate increase in the debt limit of $2.7 trillion.

Although the House was expected to vote on the Boehner plan on 28 July, Republicans could not muster the votes to pass the bill and voting was postponed. A House vote on the Boehner plan may still take place, although the situation is very fluid. The White House opposes the two-step process included in the Boehner plan, and has indicated the President may veto the bill if it is presented to him. In any case, the House plan has little or no chance of passage in the Senate.

Meanwhile, media reports indicate that Senate Majority Leader Reid is delaying consideration of his plan until the House votes on Speaker Boehner's proposal. The Senate Majority leader has hinted that if the House approves the Boehner plan and the Senate follows through with passage of the Reid proposal, it may be possible to reach a compromise on final debt legislation.

Notably, neither the House or Senate proposals include new revenue as part of a strategy to reduce the federal deficit, although revenue and tax reform could be recommended by a joint legislative committee that both plans would create.

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New *Stop Tax Haven Abuse Act* introduced in Congress

Senators Carl Levin (D-MI), Kent Conrad (D-ND), Bill Nelson (D-FL), Bernie Sanders (D-VT), Jeanne Shaheen (D-NH) and Sheldon Whitehouse (D-RI) introduced S. 1346, the *Stop Tax Haven Abuse Act*, in the Senate on 14 July 2011. In his statement on introduction of the bill, Senator Levin described the proposed legislation as intended to address "offshore tax abuses." The bill is substantially similar to the bill introduced in 2009 with the same name, S. 506

New in this year's version of the bill are provisions that would:

- Authorize special measures against foreign jurisdictions, financial institutions, and others that impede US tax enforcement;
- Modify specific rules within the Foreign Account Tax Compliance Act (FATCA) provisions;
- Treat outbound credit default swap payments as US-source income subject to withholding tax;
- Treat funds deposited by or on behalf of a controlled foreign corporation as a constructive distribution to its US shareholder for purposes of subpart F; and
- Require SEC reporting of company financial information on a country-by-country basis.

Provisions included in this year's version of the bill that are repeated from the 2009 bill would:

- Treat certain foreign corporations managed and controlled in the United States as domestic corporations;
- Require additional reporting by withholding agents with respect to US beneficial owners of certain foreign entities and by financial institutions with respect to certain financial accounts;
- Modify and expand John Doe summons procedures;
- Modify the requirements for foreign financial account reporting;
- Increase penalties for promoting "abusive tax shelters" and aiding and abetting the understatement of tax liability;
- Prohibit contingent fee arrangements;
- Direct federal banking agencies and the SEC to develop examination techniques to detect potential violations of certain tax-shelter-related provisions by financial institutions;
- Authorize Treasury to share certain tax information with the SEC and other regulators under certain circumstances;
- Provide more detailed rules with respect to Congress's subpoena authority regarding certain tax information; and
- Require the Secretary of the Treasury to impose certain tax opinion standards.

The new version of the bill does not contain some provisions that were included in the 2009 bill (including some provisions that have since been enacted in some form). Notably, the bill no longer contains a provision for a list of "offshore secrecy jurisdictions."

As has occurred in prior years, provisions in the bill could be incorporated in other legislation. Thus, developments with respect to provisions of the bill should be monitored closely, particularly with the continuing legislative focus on provisions that raise revenue or are considered as "closing loopholes."

Congressional tax committees hold joint hearing on tax treatment of debt, equity

The House and Senate tax-writing committees held a rare joint hearing on 13 July 2011 on the perceived bias in the tax system in the treatment of debt over equity, problems this bias may pose to the economy, and to potential solutions that could be addressed through tax reform. Several witnesses specifically targeted financial institutions as being over-leveraged. This was the first joint hearing between the Senate Finance Committee and House Ways and Means Committee on tax issues since 1940.

IRS news

Final regulations under Section 956 issued on determining basis for certain US property

On 24 June 2011, the IRS issued final regulations under Section 956 regarding the determination of basis in certain "specified US property" acquired by a controlled foreign corporation (CFC) in certain nonrecognition transactions that could otherwise allow a CFC to repatriate its earnings and profits without incurring US tax.

The final regulations adopt the provisions of the temporary regulations issued on 24 June 2008 (the 2008 Regulations) with certain minor changes.

More specifically, the final regulations (as did the 2008 Regulations) target transactions where a CFC acquires treasury stock or obligations of a domestic corporation that constitutes US property under Section 956(c)(1) from the domestic issuing corporation (specified US property) in exchange for stock of the CFC and other property in certain nonrecognition transactions where the basis of the property received by the CFC is determined under Section 362(a).

Taxpayers were taking the position that the acquisition of parent stock by the CFC in such transactions would not give rise to a Section 956 inclusion, because the CFC was acquiring the stock with a zero basis.

The issuance of the final regulations, as well as the issuance of final regulations under Section 367(b) (the so-called Killer B regulation), reflects Treasury's and the IRS's continued focus on US multinationals' repatriation of foreign earnings without having such earnings subject to US tax. Note, however, that the final regulation applies solely for purposes of Section 956 to address a repatriation concern and does not change the basis for other purposes of the Code.

The final regulations apply to transactions occurring on or after 24 June 2011.

Notice 2011-53: revised timelines for implementing FATCA info reporting and withholding regime

The IRS issued Notice 2011-53 on 14 July 2011, describing phased-in timelines for implementation of the requirements of the Foreign Account Tax Compliance Act (FATCA) provisions. The Notice provides additional time for participating foreign financial institutions (participating FFIs) and US financial institutions (USFIs) to implement the requirements related to account identification, information reporting, and withholding.

The key timeline points include the following:

- An FFI must enter into an agreement with the IRS by 30 June 2013, to ensure that it will be identified as a participating FFI in time to allow withholding agents to verify that no withholding is required with respect to such FFI as of 1 January 2014.
- The effective date of an FFI Agreement entered into any time before 1 July 2013, will be 1 July 2013. The effective date of an FFI Agreement entered into after 30 June 2013, will be the date the FFI enters into the FFI Agreement.
- The periods for completing due diligence requirements for pre-existing accounts are staggered, with the first tranche of such accounts required to be documented within one year of the effective date of the FFI Agreement, and all tranches of pre-existing accounts required to be documented within two years of the effective date of the FFI Agreement.
- Reporting requirements generally will begin in 2014.
- Withholding on US-source fixed and determinable, annual or periodic income (e.g., dividends, interest, etc.) generally will begin on 1 January 2014.
- Withholding on all withholdable payments (including on gross proceeds) and pass-through payments will be fully phased-in by 1 January 2015.
- Participating FFIs will not be required to calculate and publish their pass-through payment percentage before the first calendar quarter of 2014.

While the Notice provides for modest extensions of key aspects of the implementation timelines, it is important to note that for the first required report there will only be a three-month window between identifying US accounts (or recalcitrant accountholders) by 30 June 2014 and reporting them to the IRS by 30 September 2014.

The government anticipates issuing proposed regulations with respect to FATCA by 31 December 2011. Final regulations are expected to be published in the summer of 2012. Treasury and the IRS also anticipate issuing draft versions followed by final versions of the FFI Agreement and information reporting forms in the summer of 2012.

Note that compliance with the FATCA requirements will be a major undertaking for financial institutions. Even with the phased-in implementation timelines provided by Notice 2011-53, FATCA compliance will be challenging and immediate planning remains imperative.

New FAQs on Schedule UTP address taxpayer queries

In eight new Frequently Asked Questions, the IRS has provided additional guidance to taxpayers and practitioners on filing and disclosing tax positions on Schedule UTP. The FAQs provide significant additional guidance for taxpayers to consider in connection with the preparation of 2010 tax returns.

New questions 5 through 12 generally address the following:

- Whether to file a blank Schedule UTP if a taxpayer has no 2010 tax positions required to be disclosed;
- The definition of when a reserve is recorded in an audited financial statement;
- Whether to disclose on Schedule UTP a tax position for which a reserve was recorded after the IRS began examining the position;
- Whether to disclose on Schedule UTP a tax position that the taxpayer previously determined to be correct, but now expects to litigate as a result of changed circumstances;
- Who discloses a tax position following a merger when the surviving corporation records a reserve for a tax position taken on the final return of the merged corporation;
- Whether taxpayers must disclose the future use of NOL or credit carryforwards;
- Whether to disclose accruals of interest on a tax reserve recorded for a pre-2010 tax position;
- Whether to disclose on Schedule UTP a reserved tax position that would result in an adjustment to a line item on a schedule or form attached to the taxpayer's Form 1120 if it were not sustained;

The Service also revised FAQ 4, which previously addressed the treatment of interest and penalties when ranking tax positions by the amount of federal income tax reserve recorded for each position. Revised FAQ 4 also addresses the use of interest and penalties when determining whether a tax position is a major tax position.

Final regulations update 2008 temporary regulations on structured passive investment arrangements

The IRS on 13 July 2011 released final regulations under Section 901 that retain the approach of the 2008 temporary regulations of treating certain foreign tax payments attributable to structured passive investment arrangements (SPIA) as noncompulsory (and therefore non-creditable).

Section 901 and Reg. Section 1.901-2(e) permit US taxpayers a foreign tax credit for income taxes paid or accrued (or deemed paid) to a foreign country, provided, among other qualifications, that such payments are compulsory. Reg. Section 1.901-2(e)(5) generally provides that a payment is not compulsory to the extent that the

amount paid exceeds the amount of liability under foreign tax law. The taxpayer must reasonably interpret foreign tax law "in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax."

The final regulations disallow foreign tax credits on payments to a foreign government arising from income attributable to a SPIA because such amounts are considered noncompulsory. The final regulations retain the approach of the temporary regulations, relying on objective criteria (rather than subjective standards) that can indicate an abusive arrangement.

The government rejected several proposed changes which would have introduced a subjective inquiry to the standard, which the Service and Treasury felt would be both unnecessary and difficult to apply.

As with the temporary regulations, the practical effect of the final regulations largely will be to stop new transactions resembling those addressed in the regulations. Many taxpayers who previously entered into these types of arrangements have already been audited by the IRS, and most taxpayers who entered into such transactions unwound them upon release of the proposed regulations in 2007. Because of the objective nature of the test, however, in limited circumstances the regulations will continue to be a trap for the unwary.

IRS tightens controls over asserting economic substance doctrine and penalty

The IRS recently issued a new Large Business and International Directive (LB&I-4-0711-015 (15 July 2011)) on the codified economic substance doctrine (ESD), providing a comprehensive set of guidelines that an examiner must follow to determine whether to assert the doctrine and impose a penalty. It also prescribes a series of "inquiries" that the examiner must develop and analyze and document in writing before seeking the IRS Director of Field Operation's (DFO's) approval for the ultimate application of the doctrine and penalty in the examination

In 2010, Congress enacted Section 7701(o),"codifying" the economic substance doctrine and added a new strict liability penalty to the Code for transactions that lack economic substance. The statute applies

generally to transactions entered into after the date of enactment: 30 March 2010.

Congress also amended Sections 6662, 6664 and section 6676 and provided a 20% strict liability penalty (40% under section 6662(b)(6) in the case of undisclosed transactions subject to the expanded accuracy-related penalty).

Following enactment of the new provision, LB&I issued Directive LMSB 20-0910-024 (September 2010), requiring the advance approval of the appropriate DFO before proposing to apply the new penalty.

New Four-Step Procedure

In general, the new Directive mandates a four-step procedure that requires significant analysis and due diligence by the examiner to determine whether it is appropriate to seek approval from the DFO to assert the ESD penalty. The four-step procedure provides a framework for examiners to carefully consider the elements of the transaction and narrows the potential breadth of the ESD.

The new Directive directly addresses previously expressed taxpayer concerns (1) that procedures be put in place to ensure the ESD penalty would not be asserted indiscriminately, and (2) that internal control checks ensure due diligence and a responsible administration of the penalty so that examiners could not be tempted to use the threat of the ESD penalty as a bargaining tool.

A "proceed with caution" tone permeates the new Directive. While this caution may spring from a strategic concern on the part of the IRS to ensure that the initial assertions of the ESD and penalty are "ironclad" and are most likely to withstand taxpayer challenges, the approach may well benefit taxpayers with "borderline" transactions where the IRS decides, for tactical reasons, to look for a better case. On the other hand, for those transactions where the assertion of the ESD and penalty are approved, the high level of upper LB&I management (and Counsel) involvement and review may have a chilling effect on taxpayer efforts to overcome the penalty in Appeals.

IRS announces major changes to APA program

The IRS on 27 July announced a major change in the Advance pricing Agreement (APA) program, which will move from the Office of Chief Counsel to the Large Business and International Division (LB&I) and be combined with the Mutual Agreement Program. The resulting Advance Pricing and Mutual Agreement Program (APMA) will be led by a new director who will report to LB&I's Director for Transfer Pricing Operations. With this realignment of the APA program and the hiring of additional APMA staff, which the IRS hopes to have on board by the end of September 2011, taxpayers should expect to see improvements in processing time for APAs.

All APAs will now be categorized as either strategic or non-strategic (i.e., an APA requiring a determination of facts or the application of well established legal principles to known facts), with the the former continuing to have Counsel involvement.

Tax treaties

New US-Hungary treaty, Swiss and Luxembourg protocols move forward

The Senate Foreign Relations Committee held a business meeting on 26 July 2011, reporting out of committee the new tax treaty with Hungary and tax protocols to the US tax treaties with Switzerland and Luxembourg.

Those agreements were the subject of a 7 June 2011 hearing in the committee.

The Hungary Treaty and the Swiss and Luxembourg protocols next will be sent to the Senate floor for consideration. Assuming Senate consent to ratification, the president must sign instruments of ratification to the treaty and protocols to complete the approval and ratification process in the United States.

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