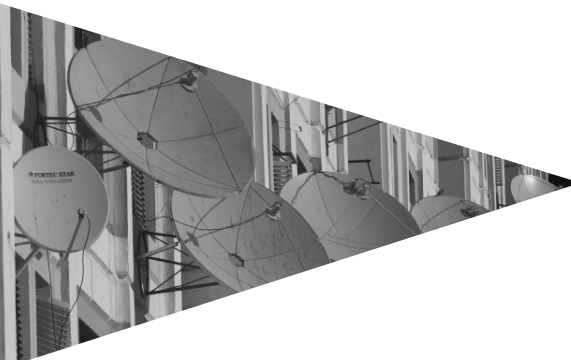


Washington Dispatch



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Legislation

Budget impasse, deficits, and tax reform dominate new Congress

Weeks after the release of the Obama Administration's proposed FY 2012 budget in mid-February, the new Congress continues to grapple with efforts to seek a compromise to fund the federal government through FY 2011, which ends on 30 September. At the same time, various Congressional committees are focusing on the options available to bring down the US's mounting deficit and debt, whether tax reform should be part of the solution and, if so, whether it should be attempted this year.

First the FY 2011 budget debate: Congress has now passed two continuing resolutions over the last month to buy time for legislators to negotiate a compromise budget to fund the federal government through the end of this fiscal year. The crux of the debate has been Republican demands that there be more than \$60 billion in cuts to discretionary spending during what's left of the government's 2011 fiscal year, with Democrats unwilling to make such deep reductions to numerous programs.

The first stop-gap spending measure was passed by the House and Senate and signed by President Obama on 2 March, thereby keeping the federal government operating two weeks, through 18 March. This averted a government shutdown, but did not result in a budget deal.

Just before the expiration of the first stop gap measure on 18 March, Congress passed another continuing resolution to fund the federal government, this time for three weeks through 8 April. Although legislators gave themselves an additional week to reach a budget compromise, Congress was in recess for the first of those three weeks (although negotiations reportedly were in process).

While Congress made several unsuccessful attempts to come up with a budget compromise, the Senate Finance and Budget Committees as well as the House Ways and Means and Budget Committees held various hearings on the interrelated issues of the deficit and tax reform.

The Senate Finance Committee on 1 March invited five former assistant Treasury secretaries for tax policy to discuss some of the fundamental issues in the tax reform debate, including the high US statutory corporate tax rate vis-à-vis the rest of the world, whether the US worldwide system of taxing earnings should be abandoned in favor of a territorial system, and how pass-through entities would be affected if reform was limited to corporate taxes.

There was general agreement, and little opposition expressed, at the hearing with regard to lowering the statutory corporate income tax rate and moving the country to a territorial system; the questions mainly involved how those goals could be accomplished. Finance Committee Chairman Max Baucus (D-MT) said in his opening statement that he intended to hold weekly hearings on tax reform.

Among the former Assistant Treasury Secretaries for Tax Policy testifying at the hearing were Mark Weinberger, EY Global Vice Chair, Tax who was Assistant Secretary from 2001 to 2002, and Eric Solomon, Director of the EY National Tax Department, who was Assistant Secretary from 2006 to 2009.

Twin hearings on tax-related issues were then held in the Senate Finance Committee and Senate Budget Committee on 8 and 9 March, respectively. The Finance Committee focused on the possibility of enacting a US consumption tax to replace the current corporate income tax, but also touched on the idea of tax reform as a tool in deficit reduction and moving the US toward a territorial tax system. Two of the three Finance Committee witnesses said the US's current worldwide system of taxation was problematic for US multinationals.

The Senate Budget Committee's hearing similarly addressed the viability of a US consumption tax, as well as moving the United States to a territorial tax system. Budget Committee Chairman Kent Conrad (D-ND), who was a member of the President's Commission on Fiscal Responsibility and Reform, said deficit reduction needed to include tax reform along the lines recommended by the Fiscal Commission (i.e., eliminating tax expenditures and reducing corporate rates). The Budget Committee Chairman noted that lawmakers were now at a critical juncture in decision-making on whether the US should move to a territorial tax system.

The day before, Erskine Bowles and former Sen. Alan Simpson (R-WY), co-chairmen of the National Commission on Fiscal Responsibility and Reform, testified before the Senate Budget Committee, making the case for reform of the tax code and entitlement programs (Medicare, Medicaid, and Social Security) as part of a comprehensive effort to address the federal budget deficit.

Bowles and Simpson argued in favor of overhauling the tax code by: 1) eliminating or greatly reducing tax expenditures; 2) lowering the individual income tax rates to 8%, 14% and 23%; and 3) reducing the corporate tax rate to 26%. In addition, Bowles said tax reform would enable the United States to adopt a territorial tax system that would make US-based businesses more competitive globally.

As March progressed, House Ways and Means Committee Chairman Dave Camp (R-MI) was reported in the press to favor reducing the top corporate and individual tax rates to 25% as part of any tax reform effort. Chairman Camp had earlier expressed support for reforms that broadened the tax base by pulling back some corporate tax preferences in order to lower the corporate rate, but he had not offered a specific plan. Treasury Secretary Timothy Geithner had told the Ways and Means Committee in mid-February that the top corporate rate would need to be reduced from the current 35% to the high-20's in order to make a "meaningful difference."

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Several witnesses at hearings held by the tax-writing committees in Congress have made similar comments.

Meanwhile, Ways and Means Chairman Camp and Senate Finance Committee Chairman Baucus in March asked the Joint Committee on Taxation (JCT) to undertake specific research with regard to debt versus equity financing and the taxation of financial instruments. The two chairmen also instructed the JCT to continue its work on tax reform to “help advance the ability of the Congress to enact comprehensive tax reform that will lower tax rates and broaden the base, reduce complexity, and promote job creation.”

Finally, the House Budget Committee weighed in on the issue of the US deficit in a hearing on 17 March that focused on the broader issue of whether cuts in spending – including to entitlement programs such as Social Security and Medicare – or revenue-raising tax changes are the best way to reduce the deficit. During an opening statement, Budget Committee Chairman Paul Ryan (R-WI) said “Medicare, Medicaid, and Social Security are growing at unsustainable rates, building up trillions of dollars in debt and unfunded promises that jeopardize the programs themselves, the federal budget, and – ultimately – the entire US economy.”

The House Budget Committee is preparing to release a budget resolution in April, and Congress will likely need to act to increase

JCT to study taxation of financial products and debt v. equity financing

The tax press is reporting that the leaders of the Joint Committee on Taxation (JCT) asked their staff to study the taxation of financial products and the treatment of debt financing versus equity financing in the Code as part of the overall congressional tax reform effort that is intended to lower tax rates, broaden the tax base, reduce complexity, and promote job creation.

Ways and Means Committee Chairman Dave Camp (R-MI) (the JCT Chair for the first session of the 112th Congress) suggested that the examination would help coordinate the approach of the Ways and Means and Senate Finance committees as comprehensive tax reform discussions continue. In his view, the study is needed because different financial products with similar financial effects and consequences are sometimes taxed differently.

For his part, Senate Finance Committee Chairman Max Baucus (D-MT) (the JCT Chair for the second session of the 112th Congress) articulated that the taxation of financial products should be “harmonized” because, in his view, the “bias” towards debt was a partial cause of the financial crisis. Notwithstanding their desire to press ahead constructively, Chairman Camp added that any tax reform would be a long process and that he did not have any immediate plans to introduce a tax reform proposal. He did indicate, however, that he would like to see the top individual and corporate tax rates lowered to 25%.

Although this announcement by the JCT does not include any substantive proposals, it highlights once again the increased scrutiny of financial products. There may be a congressional report, possibly from both houses. The use of financial products has been a hot topic in reform, in part because such groups as the Center for American Progress have started researching their use.

It remains to be seen how any reform would “harmonize” the taxation of financial products. However, harmonizing the taxation of financial products might be viewed as a potential revenue-raiser and taxpayers can anticipate that such reform likely would include requiring them to present more comprehensive arguments (and supporting documentation) to justify financial products transactions. Nevertheless, as Chairman Camp noted in his comments, the examination into this area will be lengthy and extensive. Therefore, taxpayers must continue to monitor relevant developments.

the federal debt limit before the end of May – an exercise Republican lawmakers have said must be accompanied by deficit-reduction measures.

Chairman Ryan is expected to produce a budget resolution that proposes reforms in entitlement programs, though he said at a public breakfast event sponsored by *Politico* on 17 March that those reforms are still under discussion. During the breakfast event, Chairman Ryan said he is not willing to raise taxes in order to protect entitlement programs. He also said he believes corporate tax reform is possible this year because of bipartisan interest in the subject, but that he would leave the specifics of that reform to Ways and Means Chairman Camp.

Closing out the month, the Senate Finance Committee announced the third in its series of tax reform hearings this year, to be held 30 March titled, *"How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives."*

New law imposes excise tax on certain payments to foreign persons

President Obama signed into law the James Zadroga 9/11 Health and Compensation Act of 2010 on 2 January 2011. The Act provides health benefits for first responders and recovery and cleanup workers who responded to the September 11th terrorist attack on the United States.

To pay for the benefits provided by the Act, Congress imposed a 2% excise tax on payments made to foreign persons on certain US government procurement contracts. The excise tax applies to payments made to foreign persons pursuant to a US government contract for (i) the provision of goods, if such goods are manufactured or produced in any country that is not a party to "an international procurement agreement" with the United States, or (ii) the provision of services, if such services are provided in any country that is not a party to an international procurement agreement with the United States. The excise tax applies to gross payments received under contracts entered into on or after 2 January 2011.

The excise tax is subject to assessment and collection in accordance with the withholding tax provisions generally applicable to payments made to foreign persons.

The new excise tax potentially affects all US government contracts with foreign suppliers entered into on or after 2 January 2011, including contracts with foreign suppliers for goods or services to be provided to US troops in Iraq and Afghanistan, neither of which countries are parties to the World Trade Organization Agreement on Government Procurement.

Treasury issues final regulations on Foreign Bank Account Reporting (FBAR)

New final regulations under the Bank Secrecy Act (BSA) have changed the Foreign Bank Account Reporting, (FBAR) filing requirements for TD F 90-22.1. These rules require US persons with a financial interest in, or signature or other authority over, a foreign financial account to file a report by 30 June of the following year.

The final regulations, issued on 24 February 2011, by the Financial Crimes Enforcement Network (FinCEN), a bureau of the US Treasury Department, generally adopt the rules contained in the proposed regulations issued on 25 February 2010, with some modifications.

Key points include the following:

- ▶ The moratorium for filings to report signature authority has ended, and it *will* be necessary to make filings by 30 June 2011, to report signature authority over foreign accounts for 2010 and, where required, prior years.
- ▶ The definition of "mutual funds" that constitute reportable financial accounts is the same as for 2009; interests in other private equity funds, hedge funds, and other "commingled funds" will not be subject to reporting.

- ▶ Persons who hold securities through a US global custodian will not be required to report any non-US “subcustody” accounts, at least in certain situations.
- ▶ The reporting requirements for US beneficiaries of trusts have been simplified.
- ▶ Persons reporting signature authority only over foreign financial accounts of their employer are not required to personally maintain records of these accounts.
- ▶ The rules allowing affiliated entities to file a consolidated report have been expanded.

The final regulations rejected several suggested changes, including the following:

- ▶ Treating FBAR reports as timely filed if they have been timely mailed, *i.e.*, adopting a “mailbox” rule similar to the Section 7502 rule for income tax returns;
- ▶ Aligning FBAR reporting deadlines with income tax reporting deadlines;
- ▶ Aligning certain FBAR definitions, *e.g.*, the definition of the term “trust,” with those that apply for income tax purposes;
- ▶ Eliminating reporting obligations that would duplicate income tax reporting obligations;

- ▶ Exempting tax-exempt entities from FBAR reporting (although the final regulations clarify the reporting obligations for such entities) or exempting accounts in certain “low-risk” countries;
- ▶ Eliminating all FBAR filing requirements for persons with signature authority over, but no financial interest in, a foreign financial account.

The preamble to the final regulations contains extensive commentary, and so the regulations must be read together with the preamble. The final regulations do not address the new income tax reporting requirements for interests in foreign financial accounts contained in Section 6038D, but note that these new rules only apply to tax years beginning after 12 March 2010.

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IRS news

Deemed distributions from DISC to Roth IRAs are not excess contributions

In *Hellweg v. Commissioner*, T.C. Memo 2001-58, the Tax Court rejected the IRS's attempt to recharacterize transactions resulting from an Interest Charge Domestic International Sales Corporation (IC-DISC) arrangement involving Roth IRAs to impose the excise tax on excess IRA contributions under Section 4973, because the Service did not challenge the arrangement for income tax purposes. The court determined that the treatment of a transaction under Section 4973 must be consistent with the treatment of such transaction for income tax purposes, because Section 4973 is intertwined with and inseparable from the income tax regime.

A typical IC-DISC arrangement provides for deferral of a portion of the federal income tax on income from exports. This is because the commissions paid to the IC-DISC are currently deductible; however, the DISC itself is not taxed. Instead, the DISC's shareholders are currently taxed on a portion of the DISC's

earnings in the form of a deemed distribution. This allows for deferral of taxation on the remainder of the DISC's earnings until those earnings are actually distributed, the shareholders dispose of their DISC stock in a taxable transaction, or the corporation ceases to qualify as a DISC.

It does not appear as though the transaction in the *Hellweg* case resulted in the income tax deferral that is normally associated with an IC-DISC arrangement because the commissions paid to the IC-DISC shortly thereafter were remitted as dividends to C corporations and taxed to such corporations. However, earnings and withdrawals from a Roth IRA are generally tax-free. Thus, by transferring funds to Roth IRAs through the IC-DISC arrangement in excess of the amounts that are allowed to be contributed, the taxpayers in *Hellweg* were able to move significant funds to entities whose earnings are permanently exempt from tax.

While interposing C corporations and paying DISC dividends currently eliminated the typical deferral benefit of the IC-DISC arrangement, it is possible that the taxpayer in *Hellweg* chose to do so to reduce

the likelihood of the Service being able to successfully challenge the arrangement as abusive in light of Congress's reaction to the court's decision *Blue Bird Body Co. & Affiliates v. Commissioner*, Docket No 1345-87 (stipulated decision entered Aug. 30, 1988). This case involved an IC-DISC owned by a taxpayer's tax-exempt Section 501 profit-sharing trust. The Service argued that the ownership of the IC-DISC stock by the tax-exempt trust was "offensive" because, in addition to the intended deferral resulting from the DISC regime, the income tax on the deemed distributions from the DISC would also be deferred. To eliminate this deferral, Congress enacted Section 995(g), which provides that deemed and actual DISC distributions are unrelated business taxable income.

In evaluating the *Hellweg* decision, it is important to note that the court did not address whether the transactions in question were properly characterized for income tax purposes. Rather, the court merely held that because the Service did not recharacterize the transactions for income tax purposes, it was precluded from recharacterizing the transactions for excise tax purposes.

IRS issues FAQs on Schedule UTP

The IRS has released a list of seven frequently asked questions designed to supplement the 2010 instructions and other IRS guidance on Schedule UTP. The questions address issues such as reporting NOLs or credit carryovers used in post-2009 returns, the inclusion of interest and penalties in determining the size and ranking of a tax position reported on Schedule UTP, and the implications to the policy of restraint.

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