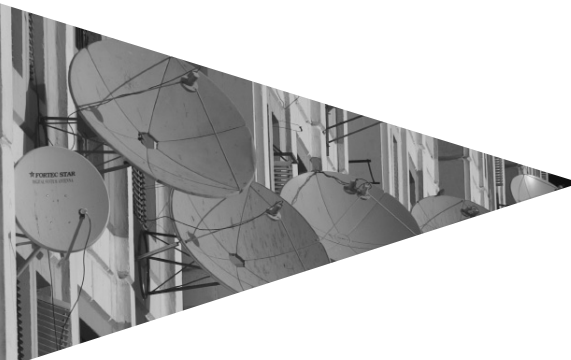


Washington Dispatch



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Legislation

President Obama delivers State of the Union; details emerge on "insourcing" proposal

President Obama delivered the State of Union address to Congress on 24 January, alluding to tax measures the President said he would propose that would eliminate incentives for US-based multinationals to move their operations overseas and encourage "insourcing." The term insourcing refers to encouraging companies to move their foreign operations back to the United States to create jobs.

Following up on the President's State of Union address, the White House quickly began to flesh out some of the tax measures, outlining six proposals that are intended to be part of the FY 2013 budget scheduled to be released on 13 February, that the Administration believes Congress should act on in the short term.

Administration officials also suggested that a framework for corporate tax reform, separate from the FY 2013 budget, would be released in February. The framework would require US-based multinational companies to pay an as-yet-unspecified minimum tax rate on overseas profits. It is unclear whether the minimum tax would apply within the current US international tax regime, or as part of a move to a territorial system. The savings from the minimum tax provision would be used to pay for tax incentives for domestic manufacturing, including making the research credit permanent.

The Administration's package intended for Congressional consideration in the near term includes the excess return proposal that has been included in prior administration budget proposals, which the administration said is aimed at preventing inappropriate shifting of profits overseas from intangible property created in the United States. Administration officials noted that House Ways and Means Committee Chairman Dave Camp (R-MI) included as an anti-base erosion option the administration proposal on intangible property in an October 2011 discussion draft aimed at moving the United States towards a territorial tax system. The intangible property proposal would raise \$23

billion, according to a White House fact sheet, which is intended to be used to offset the cost of proposals intended to encourage domestic job creation.

The administration also proposed to deny the deduction for expenses associated with a domestic company moving operations overseas. A new income tax credit would be provided for the expenses of companies moving operations back to the United States.

The plan also calls for more narrowly targeting the Section 199 deduction for domestic production activities to exclude oil production, and doubling the deduction, to 18%, for advanced manufacturing technologies. A new Manufacturing Communities Tax Credit would provide \$2 billion-per-year in incentives, over three years, for new investments in areas that have experienced a plant or military base closing.

Taking an earlier proposed idea, the new package calls for extending 100% expensing for 2012. Further, \$5 billion in tax credits would be provided to encourage roughly \$20 billion in domestic clean energy manufacturing.

The Obama Administration also proffered certain individual tax proposals that revolved around the theme of requiring the wealthy to pay their fair share of taxes. The President provided more specifics to the so-called "Buffett Rule" he announced last September, saying those individuals with incomes over \$1 million annually should pay a minimum 30% effective tax rate. The

Blueprint for an America Built To Last – Corporate and Individual Tax Proposals

Corporate

- ▶ End inappropriate shifting of profits overseas from intangible property created in the United States;
- ▶ Eliminate tax deduction US companies receive for expenses related to moving operations overseas;
- ▶ New tax credit to cover moving expenses for companies to relocate production from overseas locations to the United States;
- ▶ Double domestic production activities deduction for advanced technology manufacturers, eliminate for oil production;
- ▶ Manufacturing Communities Tax Credit to finance new factories, production in distressed areas;
- ▶ 100% expensing of investments in plants and equipment for 2012;
- ▶ Tax credits for domestic clean energy manufacturing;
- ▶ Require US-based multinationals to pay a minimum tax rate on overseas profits;
- ▶ Make research credit permanent.

Individual

- ▶ 30% minimum effective tax rate on incomes over \$1 million;
- ▶ End certain government subsidies for incomes over \$1 million.

proposal also calls for ensuring those with incomes over \$1 million do not benefit from government subsidies, such as food stamps, unemployment benefits, and farm subsidies.

The President addressed a Congress that returned from the holiday recess earlier in the month to begin the second session of the 112th Congress.

Although jobs and the deficit will continue to take center stage in Washington over the coming

months, Congress' immediate task will be to negotiate an agreement to extend through the rest of 2012 the payroll tax cut and unemployment benefits as well as prevent a cut in reimbursement payments to Medicare providers. Congress has until 29 February to pass the legislation or face the prospect of expiration of those provisions. (See page 3 for details on the payroll tax cut negotiations.)

Congress returns to Washington; Payroll bill conferees hold first meeting

Congress returned from the holiday recess in mid-January with jobs and the deficit expected to be high on the agenda over the coming months. Congress' immediate task will be to negotiate an agreement to extend through the rest of 2012 the payroll tax cut and unemployment benefits as well as prevent a cut in reimbursement payments to Medicare providers. Congress has until 29 February to pass the legislation or face the prospect of expiration of those provisions.

House-Senate conference committee charged with developing a longer-term extension of payroll tax relief and the other measures met for the first time on 24 January 2012, mostly to deliver opening statements. The conference is officially being held on H.R. 3630, as passed by the House (*Middle Class Tax Relief and Job Creation Act of 2011*) and amended by the Senate (*Temporary Payroll Tax Cut Continuation Act of 2011*).

House Ways and Means Committee Chairman Dave Camp (R-MI), who serves as chairman of the conference committee, said the main issues in the conference are that the House put forth a plan for a one-year extension of the provisions with sufficient offsets, while the Senate bill extended the provisions only through February, with no indication of how to pay for a longer-term extension. He said differences in

positions between the House and the Senate are complicated by the fact that the Senate version is now law as a result of the passage of H.R. 3765, meaning that, under House procedures, the scope of conference is effectively limited to the House bill.

Senate Finance Committee Chairman Max Baucus (D-MT) noted in an opening statement that, in addition to payroll, health, and unemployment provisions, the conference presents "an opportunity to extend other provisions that expired at the end of 2011, commonly known as tax extenders."

Chairman Camp reportedly said later that he believed tax extenders were outside the scope of the current House-Senate conference committee negotiations.

The next conference meeting is scheduled for 1 February 2012. Chairman Camp said he expected the meeting would be used to discuss the length of proposed program extensions and unemployment benefit program reforms.

Courts

UK "windfall profits" tax not creditable for US foreign tax credit purposes

In *PPL Corporation, et al. v. Commissioner*, the US Court of Appeals for the Third Circuit reversed a US Tax Court decision that allowed for a US foreign tax credit with respect to a UK "windfall profits tax" that was imposed on a number of state regulated utilities.

The Court of Appeals held that the windfall profits tax, computed on the basis of a formula whose primary variable referenced profits earned over a multi-year period, was not a creditable income tax for purposes of Section 901 because the tax did not meet the "gross receipts" test under Reg. Section 1.901-2(b)(1).

The Court of Appeals' decision will likely have an impact on those taxpayers that claimed foreign tax credits for windfall taxes paid in the UK. UK utilities companies which were privatized between 1984 and 1996 should consult with their advisors on the appropriate actions that they should be taking as a result of this decision.

On a broader note, the *PPL Corp.* decision provides helpful guidance for analyzing a foreign tax to determine whether the tax is a creditable foreign tax for US tax purposes. The decision clarifies that in order for a foreign tax to be a creditable tax, the predominant character standard applies to each of the three factors relevant for determining creditability of a foreign tax, the realization, gross receipts and net income tests. It is insufficient that the tax is the functional equivalent of a foreign tax that would satisfy the three factor test. If foreign law is levying a tax on a tax base that is in excess of actual gross receipts, the tax will not be a creditable tax, regardless of whether the tax could have been expressed as a tax on actual gross income.

IRS news

Temporary regulations on interest allocation issued

On 13 January 2012, the Treasury Department and Internal Revenue Service issued temporary regulations (the Revised Temporary Regulations) providing guidance on the allocation and apportionment of interest expense by corporations owning a 10% or greater interest in a partnership as well as the allocation and apportionment of interest expense using the fair market value method (the FMV method).

The new regulations make significant changes to the regulations governing interest expense apportionment. The Service had previously stated that guidance under Section 861 would be issued but failed to disclose the scope of the guidance. It is not clear, therefore, if additional guidance will be forthcoming.

In particular, the Revised Temporary Regulations amend the prior temporary regulations governing the application of the FMV method to “make clear” that related party debt is an asset in the hands of the creditor for purposes of applying the asset method and is included in the valuation of stock of a related person. For purposes of applying the FMV method, the Revised Temporary Regulations are effective for tax years *ending* on or after of their publication in the Federal Register (i.e., 17 January 2012). In other words, for calendar year taxpayers, these rules are effective in 2012.

The Revised Temporary Regulations amend the prior temporary regulations to “clarify” that a corporate partner with a 10% or greater interest in a partnership allocates its direct interest expense to all of its assets, including its proportionate share of partnership assets. These amendments are effective for taxable years that *begin* after the effective date of the Revised Temporary Regulations (i.e., 17 January 2012). For calendar year taxpayers, these rules therefore will be effective in 2013.

The temporary regulations also contain conforming amendments necessary to reflect the changes to Section 864 made under the 2010 Education Jobs and Medicaid Assistance Act (Pub. L. No. 111-226).

Taxpayers should review their method of apportioning interest expense with respect to their interests in partnerships to determine whether such methods are consistent with the Revised Temporary Regulations. In addition, taxpayers that use the FMV method for apportioning interest expense should carefully review their treatment of intercompany debt. Because the regulations apply to “taxable years” that end on or after 17 January 2012, the regulation must be applied to the whole year; therefore, taxpayers will need to consider the effect of these changes on their assets’ beginning of year values, keeping in mind that the FMV of an asset is the average of the beginning and end of year values.

Taxpayers that currently use the FMV method for interest expense apportionment may want to consider whether switching to an alternate method, such as the tax book value method, is advisable. In order to change from the FMV method to an alternate method, consent of the IRS is required.

New regulations address dividend equivalent payments under Section 871(m)

The government on 19 January 2012 released temporary ([T.D. 9572](#)) and proposed ([REG-120282-10](#)) regulations providing guidance on when a derivative contract over a US equity security is a “specified notional principal contract” (specified NPC) under Section 871(m), such that any “dividend equivalent” amounts on it will be subject to dividend withholding tax (30%, subject to reduction by treaty) when credited to a non-US person or entity.

In very welcome news, the temporary regulations provide that the interim statutory definition of a specified NPC, which was scheduled to sunset on 18 March 2012, will remain applicable through 31 December 2012. The temporary regulations thus postpone the effect of Section 871(m)(3)(B), which otherwise would have made *any* notional principal contract a specified NPC after 18 March 2012.

The temporary regulations also contain guidance about the mechanics of withholding under these rules,

which provide that, in some cases, a withholding agent must deposit tax “withheld” with the government, even if the withholding agent cannot collect the money from the taxpayer.

The proposed regulations propose additional categories of specified NPCs and modify existing categories, extend the scope of Section 871(m) beyond swap contracts, and provide additional guidance on swaps over baskets of equities. The proposed regulations are proposed to apply to payments made after the regulations are adopted in final form; existing contracts will not be grandfathered. While it is hoped that the proposed regulations will be finalized by (and presumably effective on) 1 January 2013, if this does not happen, it is not clear what definition of specified NPC would apply after 2012 and before the proposed regulations are issued in final form.

IRS to withdraw 2007 coordinated issue paper on cost sharing buy-in transactions

IRS Transfer Pricing Director Samuel Maruca announced recently that the IRS will withdraw its 2007 coordinated issue paper, LMSB-04-090762, (the CIP) addressing buy-in payments for intangible property made available to cost-sharing arrangements (CSAs). Maruca made the announcement at a Pacific Rim Tax Institute conference on 19 January 2012.

The IRS released the CIP in September 2007, following its identification of cost sharing as a Tier I issue, for the purpose of providing internal guidance

to IRS personnel on the methods that may be used to evaluate the buy-in payment for pre-existing and subsequently acquired intangible property made available to a qualified CSA. The CIP was a comprehensive statement of the IRS's position on the issues that exist with respect to positions for IRS agents and economists to use in evaluating the adequacy of cost sharing buy-in payments. The CIP was directed at what IRS perceived as potential abuses in the valuation of the intangible property contributed to a CSA.

The CIP generally advocated that IRS agents and economists choose, as the best method to evaluate a buy-in, certain transfer pricing methods first described in the 2005 proposed cost sharing regulations: the income method (foregone profits), the market capitalization method, the acquisition price method, and a revised version of the residual profit split method (RPSM). The CIP rejected taxpayer use of the comparable uncontrolled transaction method (CUT) and RPSM as the best methods to value a cost sharing buy-in. These methods were subsequently specified in temporary regulations effective on 5 January 2009 and final regulations effective on 16 December 2011.

Maruca said that the CIP was being mistakenly used, in many cases as a “blueprint” and applied as blanket advice for transfer pricing cases. Instead, he signaled that transfer pricing must be handled on a fact-specific, case-by-case basis. Maruca noted that while the

2007 CIP required consideration of certain circumstances of a case, it “acquired a “life of its own” and was routinely applied by IRS International Examiners without adequate consideration of the facts.

In withdrawing the guidance, Maruca said the IRS plans to return its focus to the specific facts of the individual cases. However, he also stated that the IRS is not renouncing income-based valuation, which he noted may remain the best method in certain circumstances.

From a technical perspective, the implications of the CIP withdrawal are limited. With the adoption of the final regulations there is little need for the CIP to provide internal technical guidance to IRS personnel on these issues. Similarly, the CIP provides no support for IRS litigating positions additional to that provided by the position's own persuasiveness. Although courts will show deference to IRS interpretative regulations, they are under no such obligation with respect to sub-regulatory guidance such as the CIP.

From a practical perspective, however, since the final and temporary regulations are more nuanced in their approach than the CIP, the withdrawal of the CIP could lead IRS International Examiners to become more attuned to the particular facts of taxpayers' CSAs. They will then be less likely to apply the “cookie cutter checklist” or blueprint type of approach that was applied under the CIP and has led to very large adjustments.

US Customs proposes new policy accepting transfer pricing adjustments

US Customs and Border Protection (CBP) has moved a step closer to adopting a policy first proposed in September 2011, which will accept transfer pricing adjustments provided that specified conditions are met.

In September, CBP published advance notice of a proposed policy change to broaden its interpretation of what constitutes a formula for purposes of using “transaction value,” and invited public comment on the proposal. CBP has now proposed to adopt the policy by revoking a prior CBP ruling and replacing it with a new ruling that allows post-importation customs

value adjustments made pursuant to a transfer pricing policy, provided that the transfer pricing policy can be shown to demonstrate arm’s length pricing under customs specific tests. CBP notes that the initial comments on the proposed change were favorable. If adopted, the revised policy will provide greater flexibility to importers making periodic adjustments to transfer prices after importation.

Importers of related-party products that may be subject to transfer pricing adjustments should consider specific action to take advantage of the new policy.

- ▶ Prepare customs specific supporting documentation: CBP’s proposal deals only with reporting adjustments made pursuant to

transfer prices that are otherwise acceptable for customs purposes. It *does not* mean that CBP will accept transfer pricing studies as support for customs value. Because the proposed policy will make adjustments easier to make, including adjustments that would result in customs refunds to taxpayers, *it is more important than ever that taxpayers’ supplement transfer pricing studies with customs-specific supporting documentation.*

- ▶ Apply for the Reconciliation Program: CBP specifies that the new proposal is intended to apply to importers using the Custom Reconciliation Program. Reconciliation allows an importer to declare a provisional value at

Revised Form 8621 publication does not reinstate suspended filing requirement for certain PFIC shareholders

The IRS published a revised Form [8621](#), *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and its [instructions](#) in December 2011. This revised Form supersedes the December 2004 revision of the Form and the February 2008 revision of the instructions.

The revised Form adds check boxes for making certain “deemed dividend” elections with respect to “passive foreign investment companies” (PFICs), and increases reporting for PFIC stock that is marked to market under Section 1296.

The revisions of the Form do *not* affect who is required to file the Form; the current rules are the same as with the December 2004 version of the Form and the February 2008 version of the instructions. Although Section 1298(f), as enacted in 2010, will increase the reporting requirements for shareholders in PFICs, these increased requirements were previously suspended under Notice 2011-55. The instructions to the revised Form state that this suspension of Section 1298(f) will remain in effect until guidance is issued under Section 1298(f) and Form 8621 is revised yet again.

The requirement that a US shareholder attach an information statement to Form 8621 when making a deemed dividend election for foreign corporations that are Section 1297(e) PFICs or terminated PFICs will not change under the revised form. However, US shareholders will need to indicate under Part I “G” or “H” that the election is being made for the taxable year.

import, and adjust to the final value up to 21 months following import. Importers must be approved to use the Reconciliation Program *in advance* of the imports whose value may be later adjusted. All importers contemplating transfer pricing adjustments should apply for reconciliation in order to benefit from the new policy.

- ▶ Supplement transfer pricing policies: CBP's proposed ruling adopting the new policy notes five specific criteria that were demonstrated by the importer. Several of these criteria (e.g., specifying products subject to customs adjustments) may not be clearly present in current transfer pricing policies. Importers may find it advantageous to conform transfer pricing policies to clearly meet the customs criteria.

IRS issues competent authority statistics

The IRS released the Large Business & International Division FY 2011 Competent Authority Statistics Report on 16 December 2011. The report provides a statistical update of the Competent Authority Program, including a summary of year-end case inventory and the average processing time of closed cases. The report also provides information regarding percentages of cases where competent authority relief has been granted and gives some indication of the relief that companies received as a result of competent authority assistance.

In the year ended 30 September 2011, the US Competent Authority received a total of 166 allocation (transfer pricing) cases. While the vast majority of the competent authority cases relate to transfer pricing disputes, competent authority also deals with non-allocation cases, such as limitation on benefits, permanent establishment or withholding tax issues. In 2011, the US Competent Authority received 141 cases due to foreign-initiated transfer pricing audit adjustments and 25 cases due to US-initiated transfer pricing audit adjustments. Expressed in percentage terms, 85% of the competent authority cases received in 2011 were due to foreign-initiated transfer pricing case adjustments compared to 77% in 2010.

During 2011, double taxation was eliminated for over 79% of the total dollar adjustments in dispute. This was accomplished by a combination of the initiating country withdrawing some or all of its adjustment and the other country allowing a correlative relief for some or all of the adjustment in dispute. During 2011, US-initiated competent authority cases were processed in 859 days on average, an increase from the 2010 processing time of 779 days on average. However, the average time to process foreign-initiated Competent Authority cases decreased from 937 days in 2010 to 847 days in 2011.

With the increasing interest in transfer pricing enforcement by tax authorities around the globe, the number of foreign-initiated competent authority cases should continue to trend upward. In addition, the IRS has also made clear its intention to step up transfer pricing enforcement which should eventually result in more US-initiated cases. Both of these factors strongly suggest that taxpayers should be knowledgeable about the competent authority process in the United States and other jurisdictions. Failure to make a timely notification of the potential need for competent authority assistance as required by certain treaties (e.g., Canada, Mexico, and Netherlands) or to timely file a request for assistance can result in denial of assistance and failure to eliminate double taxation.

The growing number of competent authority cases has threatened to overwhelm the US Competent Authority staff. However, the staffing has been increased recently by the addition of more than 35 analysts, economists and managers, which should help improve case processing times. In addition, the introduction of an arbitration provision in the US tax treaties with Belgium, Canada, France and Germany, should also assist in resolving double tax disputes in a much shorter period of time and in a more efficient manner.

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