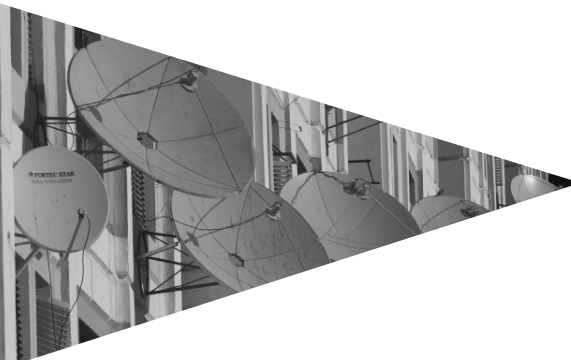


# Washington Dispatch



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## Legislation

### Focus turns to President Obama and new "joint committee" as debt deal falls short

With global reaction to the US government's debt deal tepid at best, September is expected to see major developments when President Obama outlines his plans to jump-start a faltering US economy, and the newly constituted "Joint Select Committee on Deficit Reduction" meets for the first time.

But first a recap of the debt deal Congress ultimately enacted, along with global reaction.

In a last minute deal that satisfied no one, the House and Senate passed legislation to raise the federal debt limit and President Obama signed the bill on 2 August, hours before the federal government officially ran out of money.

The *Budget Control Act of 2011* (Budget Act) first imposes caps on discretionary spending of \$917 billion, and then raises the federal debt limit between \$2.1 trillion and \$2.4 trillion in three stages (enough to carry the government through the 2012 elections):

- ▶ A \$400 billion immediate increase
- ▶ A \$500 billion additional increase, if a resolution of disapproval is not enacted
- ▶ An additional increase of between \$1.2 trillion and \$1.5 trillion, depending on actions of a 12-member joint committee of Congress and/or passage of a balanced budget agreement

With passage of the *Budget Control Act of 2011*, the Senate on 2 August joined the House in recessing for the month of August. Global financial markets generally viewed the US debt deal as unsatisfactory. In a very controversial action, Standard & Poor's (the bond rating agency) downgraded the US government bond rating, the first time in US history that US bonds had been downgraded from their top rating. Although other bond rating agencies did not follow suit in downgrading US bonds, the news added to the

belief that the US government had failed to take the necessary action to deal with the US's ongoing deficit and debt crisis.

### **"Joint committee" chosen**

Congressional leaders meanwhile moved forward and chose the 12 members of the Joint Select Committee on Deficit Reduction. The debt committee, required by the Budget Act, consists of six Republicans and six Democrats from both Houses of Congress. The new "joint committee" is charged with producing recommendations, including legislative language, to reduce the deficit by \$1.5 trillion over the period of 2012 through 2021.

The first meeting of the joint committee must occur no later than 16 September (45 days after enactment of the Budget Act).

By 14 October 2011, each committee of the House and Senate may submit recommendations to the joint committee, which opens the door for committees like the House Ways and Means Committee and Senate Finance Committee to submit ideas to the joint committee. The joint committee itself will also have the ability to hold its own hearings.

Ways and Means Committee Chairman Dave Camp (R-MI), a member of the newly formed joint committee, indicated that he would not support the committee recommending tax increases and that it should not address tax reform. "Tax reform should be about tax reform, not about deficit reduction or raising revenue," Chairman Camp said.

Under the Budget Act, the committee is also required to vote by 23 November 2011 on:

- ▶ A report that includes a detailed statement of findings, conclusions and recommendations of the committee, including the Congressional Budget Office's estimate of the recommendations
- ▶ Legislative language to carry out the committee's recommendations

If the joint committee actions do not result in a bill enacted by 15 January 2012, or if the bill produces less than \$1.2 trillion in deficit reduction over 10 years, then across-the-board sequestration, split between discretionary spending (with certain limitations) and defense spending for FY 2013 and later, takes effect beginning 2 January 2013.

### **President Obama's upcoming proposals**

Meanwhile, against the backdrop of more troubling economic news and wild fluctuations in the markets, President Obama in mid-August announced he would deliver a speech in September where he will outline new major initiatives to increase jobs and tackle the deficit and debt. The initiatives reportedly will include new tax proposals that would go beyond those that have already been proposed. According to press reports, the proposed plan would include both tax cuts and infrastructure spending to increase job growth. The White House also continued its refrain about closing "tax loopholes" as a means to raise revenue.

The Congressional Budget Office (CBO) on 24 August then set the stage for the next chapter in the budget debate, issuing a mid-year update of its budget and economic outlook, projecting a \$1.284 trillion deficit for fiscal year 2011. Oddly enough, the news was better than expected as it represented a nearly \$200 billion reduction from the \$1.48 trillion projection for FY 2011 CBO released in January.

## **Treasury Assistant Secretary for Tax Policy joins Ernst & Young**

Ernst & Young in mid-August announced that Michael Mundaca will return to Ernst & Young from the Treasury Department, where he most recently served as Assistant Secretary for Tax Policy. Mundaca, a former EY International Tax Services partner, will co-lead the firm's National Tax Department with Eric Solomon (himself also a former Treasury Assistant Secretary for Tax Policy) and be based in Washington, DC. He will also help lead EY's Americas Tax Center, launching in October 2011 as a virtual network integrating key global and Americas tax functions to provide clients with seamless cross-border tax services.

Over the 2012-2021 period, the deficit is projected to be \$3.487 trillion, taking into account the minimum \$1.2 trillion in additional deficit reduction required by the Budget Act, either to be developed by the new joint committee or through automatic cuts if the joint committee fails to find at least that level of revenue. The 10-year figure is down significantly from the \$6.971 trillion estimate for 2012-2021 CBO released in January, largely because of the effects of the Budget Act.

Importantly, the CBO projections assume expiration of provisions enacted in the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, which extended corporate tax provisions and the Bush tax cuts. CBO said much of the projected decline in deficits year-by-year occurs because revenues will climb sharply under current law, in large part owing to the expiration of tax provisions.

The federal debt debate will resume after Labor Day, when Congress is scheduled to return from its August recess. Worth noting, Treasury Secretary Timothy Geithner in

June was quoted as saying that the Obama Administration would release a corporate tax reform proposal in the form of a white paper in late summer or early fall. Although there has been little said of the white paper since then, the tax press at the time reported that the proposal would address corporate tax “loopholes” outlined in the last State of the Union address as well as a proposal to tax large pass-through entities in the same manner as corporations.

## IRS news

### IRS issues memorandum on DCLs, application of SRLY rules

The IRS on 5 August 2011 issued a Generic Legal Advice Memorandum (GLAM) (AM2011-002) that outlines how the separate return limitation year (SRLY) rules apply to the computation of consolidated taxable income (CTI) for an affiliated group with dual consolidated losses (DCLs) attributable to a foreign separate unit.

The GLAM provides important clarification—albeit not exhaustive—on how the SRLY/cumulative register concept contained in Reg. Section 1.1502-21 as adopted

operates in the context of the DCL rules. It also explains how, under certain circumstances, a DCL of a separate unit may be used in the computation of the domestic parent’s CTI for a particular year even if the domestic parent does not make a domestic use election with respect to the DCL.

The cumulative register concept is complex and can be easily misapplied, particularly because the DCL regulations themselves only contain implicit references to the SRLY operative rules. The GLAM makes clear that in certain cases, a DCL of a separate unit can be used to calculate CTI of the consolidated parent group in a year where a domestic use election for the DCL is not made, depending on the positive contributions to CTI that the separate unit has made in prior years.

Less clear under the GLAM is the start date of the cumulative register for DCL purposes with respect to a separate unit, because the effective dates of the Reg. Section 1.1502-21 regulations introducing the SRLY rules varied depending on a taxpayer’s facts. Because those rules generally applied to consolidated return years beginning on or after 1 January 1997, it is reasonable to infer from the language of the GLAM that a separate unit’s cumulative register could begin as early as that date. Considering that the SRLY concept was introduced in 1991, an open issue is whether, and under what circumstances, a separate unit’s cumulative register could begin prior to 1 January 1997.

### No Senate action on proposed US-Hungary treaty, protocols with Switzerland and Luxembourg

The Senate recessed for the congressional August recess without approving the pending tax treaty with Hungary, or protocols to the existing tax treaties with Switzerland and Luxembourg. The Senate is holding pro forma sessions periodically throughout the August recess (to prevent the President from making recess appointments), but no legislative business is expected to be conducted.

Taxpayers often focus their DCL due diligence on making domestic use elections, which then require annual certifications, and careful monitoring of whether triggering events have occurred requiring rebuttal or DCL recapture. AM 2011-002 points out that an equally important consideration is whether such an election is required, taking into consideration the separate unit's cumulative register.

The GLAM also has implications for taxpayers that make a domestic use election with respect to a DCL but then have a triggering event as described in Reg. Section 1.1503(d)-6(e) requiring the taxpayer to recapture and report as ordinary income the amount of the DCL. Reg. Section 1.1503(d)-6(h)(2) permits a taxpayer to reduce the amount of this recapture by the amount by which the DCL would have offset other taxable income for any taxable year up to and including the year of the triggering event if no domestic use election had been made for the loss such that the loss was subject to the domestic use limitation rules, including the provisions of Reg. Section 1.1503(d)-4(c). The application of the cumulative register concept described in the GLAM would apply for purposes of this rebuttal rule as well.

### **IRS confirms UK Remittance Basis Charge is creditable tax for foreign tax credit purposes**

On 11 August 2011, the IRS issued Revenue Ruling 2011-19 confirming that a credit is allowable under

Section 901 for the UK's £30,000 Remittance Basis Charge (RBC).

The ruling confirms that the £30,000 RBC qualifies as an income tax under Regulation Section 1.901-2(a)(2) and therefore is an allowable tax for foreign tax credit purposes.

Individuals resident in the UK for tax purposes but who are non-domiciled may claim the remittance basis of assessment whereby they are taxed on UK source income and gains but their foreign income and gains are subject to UK tax only if remitted to or otherwise received in the UK. Non-domiciled individuals aged 18 and over, who have been resident in the UK for any part of 7 out of the previous 9 tax years, are also required to pay an additional tax charge (RBC) of £30,000 per annum if they elect the remittance basis of assessment.

Individuals subject to the RBC must make a nomination of foreign income and/or capital gains on the UK Tax Return to validate the claim to the remittance basis. The minimum amount which can be nominated is £1. Where an individual nominates insufficient income or gains to produce the £30,000 RBC, the UK legislation effectively increases the individual's income tax liability to produce the full £30,000 RBC.

This recent IRS ruling is a welcome announcement as US taxpayers now have certainty that the RBC is a creditable foreign tax to the extent all other legal requirements for obtaining a foreign tax credit are met.

Although as little as £1 can be nominated for the purpose of the RBC, it is interesting to note that where a foreign tax is based only or predominantly on imputed income, the tax would not meet the requirements of a foreign tax for the purposes of IRC Section 901. Where insufficient income or gains are nominated, the tax base would include imputed income. The ruling concludes that the RBC is not based only or predominantly on imputed income on the basis that it is highly unlikely that substantial numbers of long term non-domiciled individuals with insufficient non UK source income to support a £30,000 tax charge would elect to be taxed on the remittance basis.

US citizens and green card holders are advised to nominate sufficient income or gains to generate £30,000 of UK tax to allow a claim under Article 24(6) of the US-UK tax treaty to be made on their US tax return to resource the nominated income/gains as foreign source against which the RBC can be utilized to reduce the US tax payable.

It is also worth noting that the ruling states that it cannot be relied upon if the UK legislation is amended in any material respect. It is currently unclear whether the IRS would consider the proposed increase to the RBC to £50,000 per annum for individuals who have been resident in the UK for 12 or more years, as outlined in HM Treasury's consultative document in June 2011, a material amendment.

## **Bulgaria and Malta added to list of treaty countries meeting requirements of Section 1(h)(11) for reduced tax on dividends from qualified foreign corporations**

The IRS on 18 August 2011 issued Notice 2011-64, adding Bulgaria and Malta to the list of countries eligible for reduced tax rates on dividends paid by certain foreign corporations under Section 1(h)(11). The law allows for a reduced capital gain tax rate on dividends paid to individual shareholders from either a domestic corporation or a qualified foreign corporation. Under Section 1(h)(11), one way a foreign corporation can be considered a qualified foreign corporation is by being eligible for benefits of a comprehensive income tax treaty with the United States.

The list of US income tax treaties that meet the requirements of Section 1(h)(11) was last updated in Notice 2006-101, 2006-2 C.B. 930.

Notice 2011-64 is effective with respect to Bulgaria for dividends paid on or after 15 December 2008, and to Malta for dividends paid on or after 23 November 2010.

Individual shareholders of corporations resident in Bulgaria and Malta may now qualify for a reduced capital gain tax rate on dividends paid from such corporations. These taxpayers should examine whether such corporations qualify for treaty benefits under the respective US income tax treaties. In addition, because of the retroactive effective dates with respect to Bulgaria and Malta, taxpayers should consider whether dividends already paid may

be eligible for the reduced rate of tax. Certain shareholders may be monitoring newly effective treaties to apply the reduced capital gain tax rate immediately rather than waiting for an updated notice, which might be issued after a return is filed (or after the statute of limitations to amend has passed). However, a notice of this type is the official designation (the Treasury Department also has the discretion to remove countries from the list, notwithstanding the status of a particular treaty).

A regulated investment company (RIC, commonly known as a mutual fund), can pass through the capital-gains-rate-eligible dividend status when the RIC pays dividends to its

own shareholders. Thus, RICs may want to update their processes to pick up dividends from corporations in these countries as well, given that if the RIC does not designate a dividend as eligible for the reduced capital gain tax rates, the RIC's shareholders cannot treat it as eligible.

The notice also clarifies that in determining whether dividends paid by a foreign corporation qualify for a reduced capital gain tax rate on dividends under the treaty test, a foreign corporation does not need to actually derive income from US sources when determining whether it would qualify for benefits under the applicable treaty.

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## International Tax Services, Washington, DC

▶ <b>Margie Rollinson</b>	<b>+1 202 327 5757</b>
<b>Sal Vaudo</b>	<b>+1 617 375 8333</b>
▶ Robert Ackerman	+1 202 327 5944
▶ Barbara Angus	+1 202 327 5824
▶ Stephen Bates	+1 415 894 8190
▶ David Canale	+1 202 327 7653
▶ Doug Chestnut	+1 202 327 5780
▶ David Golden	+1 202 327 6526
▶ Liz Hale	+1 202 327 8070
▶ Lilo Hester	+1 202 327 5764
▶ Stephen Jackson	+1 212 773 8555
▶ Karen Kirwan	+1 202 327 8731
▶ Kyle Klein	+1 202 327 8843
▶ Richard Larkins	+1 202 327 7808
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▶ Dick McAlonan	+1 202 327 6025
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▶ Al Paul	+1 202 327 7476
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▶ Julio Jimenez	+1 212 773 5297
▶ Petya Kirilova	+1 202 327 6075
▶ Tammy LeGrys	+1 202 327 7757
▶ Katherine Loda	+1 212 773 6634
▶ John Morris	+1 202 327 8026
▶ Jasper Nzedu	+1 202 327 6203
▶ Ben Orenstein	+1 212 773 4485
▶ Karen Petrosino	+1 212 773 0375
▶ Julia Tonkovich	+1 202 327 8801
▶ fax number	+1 202 327 6721

## International Tax Services

- ▶ Global ITS, **Jim Tobin**, *New York*
- ▶ ITS Director, Americas, **Jeffrey Michalak**, *Detroit*
- ▶ ITS Director of National Washington, DC, **Margie Rollinson**, *Washington*
  
- ▶ Northeast  
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ITS Washington, DC  
Margie Rollinson

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