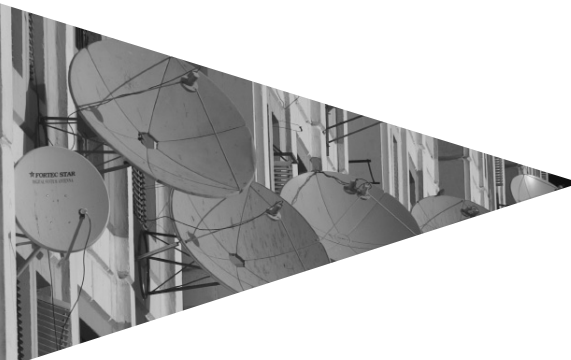


# Washington Dispatch



## In this issue...

### Legislation

- 1 Obama Administration sends jobs stimulus package, deficit reduction plan to Congress
- 3 Congressional "supercommittee" begins work

### IRS news

- 3 IRS proposes rules on Section 1256 and notional principal contracts
- 4 2011-2012 Priority Guidance Plan contains numerous international tax projects

### Courts

- 5 Ninth Circuit affirms *Samueli* but removes implication all securities loans must be terminable on demand

## Legislation

### Obama Administration sends jobs stimulus package, deficit reduction plan to Congress

Congress returned from its August recess on 6 September with new urgency regarding the economy, particularly with respect to jobs and the deficit. The month of September also saw President Obama staking out his positions on the economy, sending Congress both a jobs stimulus package as well as a deficit reduction plan.

The President first addressed a joint session of the newly convened Congress in a nationally televised address on 8 September, outlining his proposals to spur job growth.

The President told the nation that his proposals, totaling \$447 billion in tax cuts and infrastructure spending, would cut both employee and employer payroll taxes for 2012 as well as provide a one year extension (through 2012) of the 100% expensing for business investments. The President also proposed a "Returning Heroes" tax credit for hiring veterans and a \$4,000 tax credit for employers hiring those who have been unemployed longer than six months.

### Jobs Stimulus Package

The White House the next week sent to Congress the legislative language for the jobs stimulus package, the *American Jobs Act of 2011*.

The jobs package included proposed revenue offsets of \$467 billion, many of which were included in the President's FY 2012 budget proposal. Among the revenue raisers, President Obama expanded his annual budget proposal to restrict the value of itemized deductions for high-income taxpayers to 28% to also include certain above-the-line deductions and exclusions from income. Specifically, his proposal would limit above-the-line deductions for self-employed health insurance and the domestic production deduction, among others, as well as the exclusion of employer-provided health insurance costs and municipal bond interest income.

Republicans in Congress quickly responded that the President's revenue-raisers were unacceptable. Although the president's revenue offset proposals are unlikely to be enacted in the short-run, the new proposal may be included in the future debate on tax reform and the deficit reduction.

### Administration's deficit reduction plan

President Obama followed up on 19 September, unveiling his plan to reduce the Federal deficit in a document titled, *Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction* (the Deficit Plan). The Administration announced that the plan will reduce the deficit by approximately \$3.1 trillion over the next decade, primarily through tax and health policy changes.

The Deficit Plan's tax policy changes are intended to raise revenue and advance the President's vision for comprehensive tax reform, which includes enacting several of the same revenue offsets included in the proposed jobs bill. Additionally, the Deficit Plan contains many proposals included in the Administration's FY 2012 Budget proposals, including almost all of the international tax revenue proposals.

As part of the Deficit Plan, President Obama called on Congress to undertake comprehensive tax reform that:

- ▶ Lowers tax rates
- ▶ Cuts inefficient and unfair tax breaks
- ▶ Cuts the deficit
- ▶ Increases job creation and growth in the United States
- ▶ Observes a new "Buffett Rule"

The Deficit Plan also describes "measures that could contribute to comprehensive tax reform or, absent such reform, act as a backstop." These measures would impact both individual and corporate taxpayers, and generally are proposed to become effective on 1 January 2013.

Measures in the Deficit Plan affecting corporate taxpayers include eliminating special depreciation rules for purchases of corporate aircraft, repealing certain oil and gas tax preferences, repealing the last in, first out and lower-of-cost-or-market methods of accounting for inventory, eliminating certain preferences for the coal industry, and modifying the tax treatment of insurance companies and products. The proposed jobs bill included the proposals on repealing the special depreciation rules concerning corporate aircraft purchases and oil and gas tax preferences. The other corporate tax proposals were included in the Administration's FY 2012 Budget.

The Deficit Plan's proposals to change the US international tax rules include:

- ▶ Deferring the deduction of interest expense related to foreign-source income not currently subject to US federal income tax
- ▶ Requiring corporate taxpayers to determine the deemed paid foreign tax credit under Section 902 on a "pooling basis"
- ▶ Taxing currently "excess returns" earned by a CFC with respect to certain intangible property transferred to it by a related US person
- ▶ Clarifying the definition of intangible property under Section 936(h)(3)(B) for purposes of Sections 482 and 367(d) and tightening the rules regarding outbound transfers of such property
- ▶ Tightening the Section 163(j) "earnings-stripping" rules for certain expatriated entities
- ▶ Modifying the tax rules applicable to dual-capacity taxpayers

The proposed jobs bill included the proposal applicable to dual-capacity taxpayers.

The Deficit Plan includes most of the international tax proposals included in the Administration's FY 2012 Budget, but not the proposal to disallow the deduction for "excess non-taxed reinsurance premiums" paid to foreign affiliates with respect to US risks, or the proposal to repeal the "boot-within-gain" rule of Section 356(a)(1) with respect to certain reorganizations.

Receiving a lot of general press coverage, the so-called “Buffett rule” would require that taxpayers earning more than \$1 million a year not pay a smaller share of their income in taxes than middle-class families. Apart from the Buffett rule, each of these individual provisions (or a substantially similar provision) was included in the Administration’s FY 2012 Budget.

While the President’s Deficit Plan does not include a detailed plan for tax reform, the plan sends a further signal regarding the President’s interest in long-term tax reform. The Deficit Plan represents only the Administration’s recommendations to Congress, which under the *Budget Control Act* of 2011 is charged with developing legislation to deliver substantial deficit reduction this fall. The *Budget Control Act* gives the so-called “Supercommittee” a deadline of 23 November to advance its own deficit reduction plan and the recommendations included in the President’s Deficit Plan may be considered in that context.

### **Congressional “supercommittee” begins work**

The new bipartisan Joint Select Committee on Deficit Reduction, tasked by the *Budget Act* with developing a deficit reduction package in order to avoid mandatory across-the-board budget cuts under a sequestration process, held its first meeting in early September. The so-called “supercommittee” is under no restrictions in terms of

how it reduces the deficit - through spending cuts, increased revenue, or a combination of both.

Although the supercommittee is unlikely to include major tax reform provisions in a bill, given the tight time constraints, there is the possibility that tax reform could take the form of a directive to the congressional tax-writing committees to develop a reform plan under certain parameters

The committee held its first hearing on 13 September, with CBO Director Douglas Elmendorf the sole witness. Much of the questioning during the hearing focused on whether cutting spending or increasing taxes is the best way to reduce the deficit, Elmendorf said doing either “at a moment when there are a lot of unused resources in the economy—unemployed workers, empty homes, unused factories and offices”—will slow the economic recovery.

The supercommittee followed up with a hearing on 22 September titled “Overview: Revenue Options and Reforming the Tax Code,” with Joint Committee on Taxation (JCT) Chief of Staff Tom Barthold as the sole witness. Committee members asked the JCT staff for more information on several tax reform issues, including which industries benefit the most from current tax expenditures, and questioned whether JCT modeling might be expanded to better reflect the macroeconomic effects of tax proposals.

Several committee members expressed enthusiasm for pursuing tax reform as part of the committee’s work. Some echoed Sen. Rob Portman’s (R-OH) comments that it is worth pursuing the “sweet spot” of tax reform that promotes growth without additional burdens using the “extraordinary procedural opportunities” given to the committee under the Budget Control Act that created it.

### **IRS news**

#### **IRS proposes rules on Section 1256 and notional principal contracts**

The IRS has issued proposed regulations clarifying when swap contracts and certain similar agreements will be subject to “mark to market” accounting and the other rules of Section 1256. These proposed regulations attempt to eliminate some of the confusion on this point that was created by the enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*.

The proposed regulations also provide that credit default swaps, weather-related swaps and certain other non-financial swaps would be treated as “notional principal contracts” for tax purposes. In the past there had been substantial confusion about how such contracts were classified. Finally, the proposed regulations would reclassify “bullet swaps” and similar transactions, which provide for only one net

payment but several dates on which components of the payment are to be determined, as notional principal contracts.

The regulations are proposed to apply to contracts entered into on or after the date that final regulations are published.

### **2011-2012 Priority Guidance Plan contains numerous international tax projects**

The IRS and Treasury on 2 September 2011, issued the 2011-2012 Priority Guidance Plan. The Plan provides an overview of the issues the government intends to address over the next nine months. As in prior years, the IRS and Treasury state that they will update and reissue the Plan periodically to reflect additional guidance that they intend to publish, to allow for consideration of comments received from taxpayers and practitioners on additional projects, and to respond to developments arising during the plan year. The Plan also indicates items that have already been published.

Of the 317 projects that the IRS and Treasury intend to complete by June 2012, 49 are international projects. While this is a slight increase in the number of international projects from the 2010-2011 Priority Guidance Plan, which identified 44 international projects out of 310 overall projects, only 11 of the identified international projects are new. The new international projects include the following.

#### **Subpart F/deferral**

- ▶ Guidance under Section 954, including final regulations under Section 954(d) relating to contract manufacturing for purposes of determining foreign base company sales income.
- ▶ Final regulations under Section 959 on previously taxed earnings and profits.

#### **Inbound transactions**

- ▶ Final regulations under Section 6049 on the reporting of bank deposit interest paid to nonresident aliens.

- ▶ Final regulations under Section 7701(l) regarding conduit financing arrangements.

#### **Outbound transactions**

- ▶ Guidance under Sections 367 and 1248.
- ▶ Regulations under Section 7874, including final regulations on the definition of "surrogate foreign corporation."

#### **Foreign tax credits**

- ▶ Guidance under Section 901 on the definition of taxpayer.

#### **Sourcing and expense allocation**

- ▶ Regulations under Sections 861, 862, and 863(a) on the source of income.

#### **Other**

- ▶ Revenue ruling under Section 274 regarding the definition of "North American area."
- ▶ Final regulations under Section 304 preventing the use of related corporations to avoid Section 304.

### **IRS addresses domestic corporation's insolvent foreign sub electing to be treated as partnership -**

In Generic Legal Advice Memorandum (GLAM) 2011-3, the IRS Office of Chief Counsel (Passthroughs & Special Industries) has issued advice concerning the federal income tax consequences of a domestic corporation's insolvent foreign subsidiary making a check-the-box election to be classified as a partnership for federal tax purposes.

While GLAM 2011-003 is an internal IRS communication and may not be used or cited as precedent, it addresses several important issues, including: whether a worthless stock deduction is allowed, whether the change in entity classification results in a substitution of a new obligor (yes), and whether a bad debt deduction was available (no).

- ▶ Regulations under Section 937(a) concerning the “presence test” for bona fide residency in US territories.

## Courts

### Ninth Circuit affirms *Samueli* but removes implication all securities loans must be terminable on demand

The Ninth Circuit has affirmed a decision of the Tax Court in *Samueli v. Commissioner*, finding that a securities lending transaction does not qualify for nonrecognition treatment because the transaction did not meet Section 1058(b)(3)'s requirement that the transferor retain the risk of loss and opportunity for gain on the transferred securities.

Importantly, the Ninth Circuit explicitly declined to address whether securities loans must be terminable upon demand to satisfy Section 1058(b)(3), noting resolution of the case did not require addressing that issue (because the transaction at issue allowed for termination only on two specified days during its 15-month term and because the terms of this transaction might have limited the opportunity for gain) and the question was better addressed by Treasury and the IRS. The appeals court wrote, “our conclusion that the transaction . . . reduced [the couple’s] opportunity for gain does *not* necessarily imply a conclusion that a securities loan

must be terminable upon demand to satisfy the requirements of Section 1058(b)(3).” In its opinion, the court also acknowledged the potential effect on commonplace market transactions that such a holding could have.

In essence, the transaction consisted of a couple purchasing stripped securities from a broker on margin, lending the strip back to the same broker in exchange for cash securing the broker’s obligation to return the strip, and paying the broker a variable rate fee for use of the cash collateral, which the couple used to repay the margin loan used to purchase the strip. When the transaction terminated, the broker

did not return the original strip but instead paid the couple its current fair value, which the couple used to return the original cash collateral plus accrued, unpaid variable rate fees. The agreement between the couple and the broker provided only two specified early termination dates.

The Tax Court had found that a securities lending transaction does not qualify for nonrecognition treatment under Section 1058 unless it gives the securities lender the right to demand return of the securities essentially at any time during the term of the securities loan. The Tax Court had also held that there was no securities loan

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under Section 1058 and, as such, the couple could not deduct the variable rate fees.

From a financial transactions perspective, the Ninth Circuit decision is welcome because it removes the implication from the Tax Court decision that a securities loan for a definite term per se cannot qualify for nonrecognition treatment under Section 1058.

The Ninth Circuit also left open the longstanding question of whether Section 1058 is the exclusive basis for obtaining nonrecognition treatment on a securities loan.

From the perspective of tax shelters and the economic substance doctrine, the case is interesting because it clearly invokes the lack of a non-tax business purpose as a part of its analysis, but does not invoke the economic substance doctrine as such. Thus, it contains no discussion of whether the doctrine applies and, if so, whether the test is conjunctive or disjunctive.

Rather, the court holds against the taxpayer on grounds similar to those invoked in *Gregory v. Helvering*, 293 US 465, 469 (1935)-the transaction does not qualify for nonrecognition

treatment under Section 1058 because it does not fit within “the underlying assumptions and purposes” of that section. Nevertheless, because of the court’s discussion of business purpose, it is possible that the IRS will view this case as giving further support to its position, based on *Coltec v. Commissioner*, that even if a transaction has an overall business purpose, the tax benefit can be disallowed if the step that gave rise to the tax benefit had no business purpose.

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SCORE no. CM2525

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