Building a better working world

Washington Dispatch

May 2022, Volume 26, Issue 5

EY's weekly and monthly US international tax podcasts are available on iTunes and ey.com:

- Listen and subscribe to the weekly podcast on iTunes
- Listen and subscribe to the monthly podcast on iTunes
- Access all podcasts on EY's Tax News Update: Global Edition tool

In this issue

Legislation

Budget reconciliation remains stalled, but with some behind-the-scenes talks

The month of May saw little movement in terms of a budget reconciliation bill, with much of Congress' attention centered around a House-Senate conference on so-called China competitiveness legislation.

Senator Joe Manchin (D-WV) reiterated that he would support a budget reconciliation bill, saying: "My main thing is inflation, fighting inflation with tax reforms." Senator Manchin also continued to call for tax rate increases that are opposed by Senator Kyrsten Sinema (D-AZ).

Senate Majority Leader Chuck Schumer (D-NY) and Sen. Manchin reportedly met several times during the month to try and reach a compromise for a limited reconciliation bill. Senator Manchin suggested he could accept reconciliation legislation that splits revenue from tax and prescription drug reform between deficit reduction and spending, probably mostly addressing climate change. Senate Democrats will try to craft a Build Back Better replacement that is expected to focus on reducing fossil fuel dependence, combating climate change, and lowering inflation.

The timing for passage of a pared-down reconciliation bill is problematic for Democrats, both in terms of reaching agreement as well as Congress' need to address a host of other major issues.

Congress returns from the Memorial Day holiday with limited time before the August recess. The House is slated to be in session only six of the remaining weeks before it is scheduled to adjourn on 1 August; the Senate will adjourn on 8 August.

While there is some speculation that the August recess represents a deadline to reach agreement on the reconciliation bill, Sen. Manchin was quoted as saying he considers 30 September to be the real deadline for budget reconciliation.

IRS news

More US FTC guidance coming

A senior Treasury official in May provided details about additional US foreign tax credit guidance that would supplement final regulations issued in December 2021. The official said the US government is considering addressing royalty withholding tax and cost recovery issues, and perhaps, at some point, more guidance on disregarded distributions in the foreign tax credit context.

Regarding foreign withholding taxes on royalties, Treasury is not going to move away from the general rule that provides a legal test that compares foreign law to US domestic law, nor will it alter the existing US royalty sourcing rule that looks to the place of use. To the extent the foreign jurisdiction has a different sourcing rule, then the requirement that the foreign sourcing rule be "reasonably similar" to the US sourcing rule will continue not to be met, the official said.

The Treasury official indicated, however, that sympathetic cases are being made and Treasury is considering a safe harbor for certain business models. He referred to an example in which a license is in place and the license only includes the right to use IP in a particular jurisdiction (and the use then occurs). Treasury could deem the source-based attribution requirement to be met in that fact pattern, and the credit would be allowed. The official added that it is probably not possible for a safe harbor provision to provide benefits that would apply to all types of business models, but it would provide some relief. According to the official, this would be a new rule and probably would come out as a notice or proposed regulation that provides an opportunity for comment. In regard to a timeline, the official said the government is still collecting feedback and any change – which would be narrowly drawn – is months away but expected to be released in 2022.

Support Ukraine Through our Tax Code Act introduced in Senate

On 12 May, Senate Finance Committee Chairman Ron Wyden (D-OR) and Senate Finance Committee Member Rob Portman (R-OH) released proposed legislation (S. 4218) that would disallow foreign tax credits for taxes paid to Russia or Belarus, and further disallow certain other US tax benefits. The *Support Ukraine Through Our Tax Code Act* closely follows the discussion draft released on 7 April 2022, with some important clarifications that center on the definition of persons in scope.

The official also was quoted as saying the IRS is considering a clarification to the foreign tax credit regulations' cost recovery rule. The clarification would explain that the cost recovery rule does not require foreign law to be identical to US law, but rather viewed as a principle, whereby: "If the principle underlying the foreign limitation is consistent with the general limitations in the code — they are based on anti-base-erosion, profit-shifting, public policy concerns, [or] base-broadening concerns — they ought to be comparable." This clarification can be expected before the proposed royalty withholding rule.

More guidance is also being considered in respect to disregarded distributions, although not as soon as other forthcoming foreign tax credit guidance.

US government officials offer update on future international projects

A Treasury official in May said the government is working on rules governing so-called "Killer B" cross-border triangular reorganizations. The IRS earlier released Notices 2016-73 and 2014-32 on the topic. The official was quoted as saying the government is "actively working on putting those into regulations."

The official further noted that the government is also working on regulations under Section 367(d) dealing with situations when intangible property is transferred from the United States and then repatriated. The official noted that the present regulations do not address the issue "so the implication right now is that if you bring it back, you are still subject to the 367(d) regime." The future guidance, which is included in the 2021-2022 priority guidance plan, reportedly will be narrow in scope but broader than existing private letter rulings that address intangible property returning to the US.

Later in the month, a senior IRS official was quoted as saying that proposed Section 1256 regulations on foreign currency contracts will be released in the coming weeks. The new rules will "address clarifications of [Section] 1256 and the definition of a [Section] 1256 contract."

Regulations under Section 897 (disposition of investment in US real property), including rules on the qualified foreign pension fund exception, are also expected "soon," according to that official.

Another IRS official said the IRS plans to issue new Section 382 proposed regulations on computing built-in gains and losses following an ownership change, instead of finalizing the 2019 proposed regulations. The official was quoted as saying that the IRS would issue a notice and review the comments before issuing another regulation package, adding "the re-proposal gives us a little bit more flexibility to be a little broader in what we want to approach."

US officials comment on BEPS 2.0 project

A senior Treasury official in May said the US is working with the OECD on the Implementation Framework to clarify the treatment of US business credits for purposes of the OECD global minimum tax rules in Pillar Two. More specifically, the official was quoted as saying that Treasury is seeking some certainty as to how US incentives would be treated under the global anti-base erosion (GloBE) rules and the related Pillar Two commentary. "We're confident that the value of many of our general business credits is preserved under the OECD rules," she said.

Another Treasury official said the US government wants additional public consultation on the draft package of Pillar One rules after the ongoing Pillar One public consultations on the major components of Pillar One end. The official said the US wants stakeholders to be able to comment on the "whole picture and provide full input." The Treasury official added that Pillar One is about stabilizing the global tax system, and "stabilization is not just about eliminating digital services taxes but also addressing the rise in transfer pricing and business profits disputes."

A Treasury official also acknowledged that there is taxpayer interest in the development of dispute resolution mechanisms in the BEPS 2.0 global anti-base-erosion (GloBE) context, but that negotiations are not yet taking place. Instead, the official said, "We are exploring what can be done with existing tools — bilateral treaties, competent authority agreements — as well as whether other tools are needed."

IRS GLAM addresses allocating and apportioning 'deferred compensation expense' for FDII deductions

The IRS Office of Chief Counsel recently released a generic legal advice memorandum (AM 2022-001) that addresses how to properly allocate and apportion amounts it calls "deferred compensation expense" (DCE) under the Section 861 regulations for calculating a taxpayer's deduction for foreign-derived intangible income (FDII).

Reversing previous guidance, the IRS asserted that so-called DCE deductions should be allocated to FDII for the tax years in which the compensation becomes deductible under federal income tax accounting principles, even if the compensation is based on employees' service in years before FDII became effective.

In GLAM 2009-001 (2009 GLAM) and CCA 201714029 (2017 CCA), the IRS addressed the allocation of deductions that related to activities occurring before Section 199's enactment but accrued following enactment. The 2009 GLAM involved deductions for deferred compensation and the 2017 CCA involved deductions of certain litigation expenses.

To the extent the deductions factually related to gross income accruing before Section 199's enactment, the IRS had concluded the deductions would be allocated/apportioned under Section 861 to statutory and residual groupings of gross income based on the statutory groupings that existed before Section 199's enactment; they would not be based on the statutory groupings that existed in the year that the deductions accrued following enactment

Nothing in the 2009 GLAM or 2017 CCA suggested that the analysis was specific to Section 199. Rather, the analysis in the GLAM and CCA interpreted Reg. Section 1.861-8.

The new GLAM will likely surprise many taxpayers, as it reverses the 2009 GLAM's longstanding guidance on the treatment of prior period expenses related to DCE. Note that Reg. Section 1.861-8(e)(5)(ii), issued in 2020, sets forth an allocation method consistent with the analysis in the new GLAM. This provision, however, applies only to litigation damages. The regulation does not expressly address the treatment of other types of prior period expenses.

The GLAM notes that the analysis "may apply to deductions other than compensation that may be seen as relating to an earlier period, such as a warranty payment resulting in a deduction allowable in 2018 that was incurred in respect of a product sold in an earlier year."

The GLAM's implications are not limited to FDII. Consistent with Reg. Section 1.861-8(e)(5)(ii), the analysis in the GLAM may apply to prior period expenses for purposes of the Section 904 foreign credit limitation.

While the new GLAM is not entitled to judicial deference, it does reflect the position of IRS Counsel. Taxpayers should assess the implications of the new GLAM for Section 861 allocation positions that they have taken, or are considering taking, for the treatment of prior period expenses.

Changes to QI withholding agreement rules expand QI withholding and reporting responsibilities

The IRS published changes (Notice 2022-23) to the qualified intermediary (QI) withholding agreement rules that will allow a QI to assume withholding and reporting responsibilities for purposes of Sections 1446(a) and (f). Generally, these changes would apply to a QI that sells an interest in a publicly traded partnership (PTP) or receives a distribution from a PTP on behalf of a QI account holder. The following are some of the highlights:

Withholding responsibility

Under Notice 2022-23, the QI agreement will be updated to allow QIs to assume primary withholding responsibility for sales of PTP interests under Section 1446(f). In addition, QIs can assume primary withholding responsibility for PTP distributions, which include distributions of:

- Effectively connected income subject to Section 1446(a) withholding
- The excess of the cumulative net income of the PTP, subject to Section 1446(f) withholding
- US source FDAP (fixed, determinable, annual, periodical) components (based on a PTP Qualified Notice) subject to Chapter 3 or Chapter 4 withholding

Documenting account holders

Proposed changes to section 5 of the QI agreement will allow a QI to document the non-US resident status of an account holder who is a partner in a PTP using either documentary evidence or Forms W-8. However, there are restrictions to using documentary evidence.

OECD releases report on strengthening tax cooperation

The OECD on 20 May issued a report for the G7 Finance Ministers and Central Bank Governors that provides recommendations to strengthen tax administrations' cooperation in the context of increasingly coordinated international rules, including the BEPS 2.0 project. The report considers the "need for a simple, collaborative, and digital administration of common rules," including how tax information exchange could evolve as well as improve "timeliness through real-time data availability and incorporating compliance by design."

Reporting on Form 1042-S

Changes to QI agreement section 8 will allow a QI to file Form 1042-S on a pooled basis to report amounts realized and amounts subject to withholding on PTP distributions, as is generally permitted for other payments governed by the QI agreement. A QI acting as a disclosing QI is not required to file Form 1042-S (unless it knows or has reason to know that a correct Form 1042-S was not issued to a partner); instead, the QI's withholding agent or broker must file the form.

Reporting on Forms 1099

For payments of broker proceeds that are amounts realized from sales of PTP interests, Section 3 of Notice 2022-23 will not exempt QIs from the responsibility of primary Form 1099 reporting and backup withholding (as otherwise permitted in Section 3.05(C)), if the QI provides the broker with a valid withholding certificate indicating that the QI assumes primary withholding responsibility for the amount realized.

OECD developments

OECD officials offer BEPS 2.0 update

An OECD official in May was quoted as saying that finalization of the BEPS 2.0 Pillar One multilateral convention will be delayed, with "practical implementation" of the convention probably taking place "from 2024 onwards." He said that the Task Force on the Digital Economy, which is developing the Pillar One Amount A model rules and multilateral convention, is now expected to finalize the rules and convention by the end of 2022, instead of mid-2022 as planned.

The OECD official also said the organization hopes to have a "principal agreement on all of the remaining technical aspects" of the BEPS 2.0 Pillar One elements when the G-20 Finance Ministers meet in Bali in July.

In regard to Pillar Two, the technical work is complete, another OECD official said, and it now falls to the various jurisdictions to implement the new rules. The official added the OECD has a list of Pillar Two guidance requests that it is prioritizing. The OECD plans to publish that guidance as soon as it is approved, but no later than the end of 2022. The OECD is also reportedly working on a standard return for Pillar Two's global anti-base erosion (GloBE) rules.

OECD releases public consultation document on Regulated Financial Services Exclusion under Amount A for Pillar One

The OECD on 6 May 2022 released a public consultation document regarding the Regulated Financial Services Exclusion under Amount A for Pillar One of the OECD/G20 BEPS 2.0 project.

The new taxing right established through Amount A applies only to those Multinational Enterprise Groups that fall within the defined scope of Amount A. The Regulated Financial Services Exclusion will exclude from the scope of Amount A the revenues and profits of a Regulated Financial Institution.

The consultation document provides a definition of Regulated Financial Services that includes seven types of Regulated Financial Institutions. The definition for each type of Regulated Financial Institution, except one (i.e., Regulated Financial Institution Service Entity) contains three elements, all of which must be met: (i) a licensing requirement; (ii) a regulatory capital requirement; and (iii) an activities requirement.

This consultation document covers Schedule [G] of the Model Rules which will govern the Regulated Financial Services Exclusion. Other parts of the Model Rules on Amount A, on which the corresponding provisions for the Regulated Financial Services Exclusion would be based, are pending finalization and therefore the Schedule for the Regulated Financial Services Exclusion provides a preliminary description and explanation of the envisaged draft rules.

The consultation document is a working document released by the OECD Secretariat to obtain input from stakeholders. It has been released on the basis that it is without prejudice as to the final agreement and it does not reflect consensus of the Inclusive Framework member jurisdictions on the substance of the document.

Ernst & Young LLP, International Tax and Transaction Services, Washington, DC

- **Craig Hillier** **craig.hillier@ey.com**
- **Colleen O'Neill** **colleen.oneill@ey.com**

- Tyler Arbogast tyler.arbogast@ey.com
- Stephen Bates stephen.bates@ey.com
- Doug Chestnut douglas.chestnut@ey.com
- Arlene Fitzpatrick arlene.fitzpatrick@ey.com
- Revital Gallen revital.gallen@ey.com
- Liz Hale elizabeth.hale@ey.com
- Lena Hines lena.hines@ey.com
- Enrica Ma enrica.ma@ey.com
- Oren Margulies oren.margulies@ey.com
- Carlos Mallo carlos.mallo@ey.com
- Marla McClure marla.mcclure@ey.com
- Mike McDonald michael.mcdonald4@ey.com
- Martin Milner martin.milner@ey.com
- John Morris john.morris@ey.com
- Chris Ocasal chris.ocasal@ey.com
- Al Paul al.paul@ey.com
- Stephen Peng stephen.peng@ey.com
- Tom Ralph thomas.ralph@ey.com
- Joshua Ruland joshua.ruland@ey.com
- Craig Sharon craig.sharon@ey.com
- Daniel Sosna daniel.sosna@ey.com
- Raymond Stahl raymond.stahl@ey.com
- Allen Stenger allen.stenger@ey.com
- Matthew Stevens matthew.stevens@ey.com
- Zach Pouga Tinhaga zach.pouga.tinhaga@ey.com
- Julia Tonkovich julia.tonkovich@ey.com
- Mathew Urbina matthew.urbina@ey.com
- Thomas Vidano thomas.vidano@ey.com
- Tim Wichman timothy.wichman@ey.com
- Michael Yaghmour michael.yaghmour@ey.com
- Jason Yen jason.yen@ey.com
- Adam P Becker adam.p.becker@ey.com
- Ted Clabault ted.clabault@ey.com
- Robert Contreras robert.contreras@ey.com
- Heather Gorman heather.gorman@ey.com
- Tanza L. Olyfveldt tanza.olyfveldt@ey.com
- Deborah Tarwasokono deborah.tarwasokono@ey.com
- Carlos J Vaca Valverde carlos.j.vaca.valverde@ey.com
- Jeshua Wright jeshua.wright@ey.com

International Tax and Transaction Services

Global ITTS Leader, **Jeffrey Michalak,** *Detroit*

Global Transfer Pricing Leader, **Tracee Fultz,** *New York*

ITTS Director, Americas, **Craig Hillier,** *Boston*

ITTS NTD Leader, **Colleen O'Neill,** *New York*

Transfer Pricing Leader, Americas, **Katherine Pinzon,** *Houston*

ITTS Markets Leader, Americas, **Jonny Lindroos,** *McLean, VA*

ITTS Regional Contacts, Ernst & Young LLP (US)

West
Sadler Nelson, *San Jose, CA*

East
James Keim, *New York*

Central
Aaron Topol, *Atlanta*

Financial Services
Chris J Housman, *New York*

Canada – Ernst & Young LLP (Canada)
Warren Pashkowich, *Calgary*

EY | Building a better working world

About EY
EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

prepared by Ernst & Young LLP's Washington International Tax Services summarizing recent developments and "inside-the-beltway" news pertinent to multinational companies. For additional information, please contact your local international Tax professional.

EYG no. 004898-22Gbl

1508-1600216 NY
ED None

ey.com