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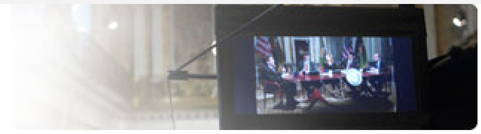

Remarks by Acting Assistant Secretary Emily McMahon at the NY State Bar Association Annual Meeting

1/25/2012

Remarks by Emily S. McMahon, Acting Assistant Secretary for Tax Policy
New York State Bar Association Tax Section Annual Meeting
Tuesday, January 24, 2012

As Delivered

Thank you. As some of you know, I attended quite a few of these Tax Section lunches during my time with Sullivan & Cromwell and Davis Polk, and I can honestly say that it never occurred to me then that someday I would be the one standing here, speaking to all of you. But I have had the great fortune more recently to join the truly extraordinary group of lawyers and economists who make up the Office of Tax Policy at the Treasury Department, and I am honored to be able to represent them here this afternoon.

I want to start by thanking the Tax Section for its important contributions to the guidance process. Your reports are read thoroughly and debated extensively, and they are invaluable in helping us to determine our priorities, frame the issues and develop sensible solutions.

Today I am going to talk about our top priorities for administrative guidance, and hopefully in so doing to provide you with some insight into Treasury's role in the guidance process and how we see it functioning today. The guidance process is always a popular topic of conversation in the tax community – just last summer, Tax Analysts hosted a conference on the subject, which sparked another round of constructive criticism and helpful suggestions. I can assure you that those of us at Treasury and IRS with responsibility for the guidance process take these suggestions seriously, and we are always looking for ways to streamline the process and improve the quality of the guidance we issue.

However, I will also say that the guidance process today is functioning more smoothly than I have ever seen it. In fact, we are about to release our second quarter update to the 2011-2012 Priority Guidance Plan, which will show that we published a total of 150 guidance projects during the first half of the plan year. I could not be more proud of the lawyers on our Tax Legislative Counsel, International Tax Counsel and Benefits Tax Counsel staffs who – together with their IRS colleagues -- are responsible for making that happen. Their hard work, dedication, creativity and collegiality has allowed us to make significant progress in completing a number of longer-term projects on the Plan, while at the same time responding to the immediate challenges of implementing the large body of tax legislation enacted over the past three years.

As observers of the process have pointed out, our staff of roughly 35 lawyers is quite small, especially when considered in the context of the 300 or so items that appear annually on the Priority Guidance Plan. As a result, we are continually re-evaluating how to allocate our resources to ensure that the most critical projects get done, and we take the best advantage of opportunities to improve the tax system.

So today I wanted to highlight the three areas that have been top priorities for us — and have provided us with some unique opportunities — over the past three years. The first is guidance relating to the financial crisis, the economic downturn and now the economic recovery. The second is guidance required to implement the Affordable Care Act, and the third is guidance to implement FATCA. A fourth priority is our work with the IRS on their tax return preparer initiative and other related efforts to improve voluntary compliance, but Commissioner Shulman and others have spoken in detail about that work so I will not go into it today.

Financial Crisis and Economic Downturn and Recovery

Let me start with our guidance relating to tax issues raised during the financial crisis and the economic downturn and recovery. First and foremost, we and our IRS colleagues have mobilized quickly to implement each of the important pieces of legislation enacted over the past few years to address the financial crisis and spur the economic recovery, including the Emergency Economic Stabilization Act of 2008 (EESA), the Recovery Act, the Small Business Jobs Act of 2010, the HIRE Act of 2010, the tax-related provisions of Dodd-Frank, and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. I cannot overemphasize the importance we place on this task. Both we and IRS have allocated substantial resources to this guidance, and it receives prompt and thorough attention at all levels within both organizations. The result is a substantial body of guidance on a wide range of subjects, from temporary relief under the HYDO rules, section 956 and other provisions, to section 108(i), bonus depreciation, tax-exempt bonds, jobs-related credits and grants under federal investment programs.

At the same time, the events of the past few years have provided a unique opportunity for us to re-examine our existing guidance under some key provisions of the Code, and we have taken that opportunity to modernize and improve that guidance. Section 382 is a good example. Our work on a series of notices designed to address the application of section 382 in the context of government programs established under EESA brought to light certain limitations of our existing guidance on issues of broader applicability, and we have taken the opportunity to update and streamline those rules. In June of 2010, we issued Notice 2010-49 requesting comments on revisions to the rules governing the treatment of small shareholders, and Notice 2010-50 on the treatment of fluctuations in stock value. We received very helpful reports on both subjects from the Tax Section, and in November of last year, we issued proposed regulations designed to simplify the rules on small shareholders. We are now working toward finalizing those rules.

The financial products area provides other examples. In January of last year, we published proposed regulations under section 1273 on determining when a debt instrument is publicly traded. This guidance was initiated in response to questions that arose frequently during the financial crisis, with its unforeseen effects on trading volume in a variety of debt markets. In developing our proposed regulations, however, we sought to update those rules more broadly to better reflect the types of markets on which debt currently trades and to adapt as those markets continue to evolve.

We have also taken the opportunity presented by the Dodd-Frank Act to update the regulations under section 1001 to accommodate the assignment of a derivative between dealers and clearinghouses. The prior regulations applied only to the assignment of a notional principal contract and were the subject of some debate in the tax community. Temporary and proposed regulations issued in July of last year eliminate that uncertainty and apply to a broader category of derivatives.

Also related to Dodd-Frank, we published regulations in September under sections 446 and 1256 that implement section 1256(b)(2)(B) and, in so doing, address the characterization of credit default swaps. These regulations set the stage for the guidance project on the timing and character of payments under a contingent notional principal contract, which we expect to publish later this plan year. That project is being coordinated with guidance on prepaid forward contracts, which is also on the current Priority Guidance Plan.

The low interest rate environment that followed the financial crisis has also created its own set of tax issues. Very low interest rates increase the incidence of failed deliveries in the delivery versus payment market. Responding to this problem, the Treasury Market Practices Group endorsed a new trading practice that institutes a fails charge in the event of a failed delivery. Guidance was needed on the tax implications of such a fails charge, and in particular whether it would be subject to U.S. withholding tax. Regulations were issued in 2010 that resolve this sourcing question for qualified fails charges. In the same vein, the move towards the safety of Treasury securities led to the issuance of Treasury Inflation Protected Securities at a premium for the first time ever in 2011. Their issuance was preceded by Notice 2011-21, prescribing the rules for accounting for premium on TIPS. Temporary regulations following up on the Notice were published in December.

Lastly, another area in which the financial and economic crises have presented us with an opportunity to update our guidance is in the treatment of distressed debt. We received a very thoughtful report from the Tax Section in November, and we are actively working to develop guidance that will clarify the accrual of interest and OID on distressed debt instruments. The clarification of the regulations under section 1.1001-3(e), released last year, is a small but useful step in that direction.

Overall, while the developments in the financial markets and the economy over the past several years have presented us with numerous challenges, I believe that we have been able to build on those challenges to reinvigorate the guidance process -- in the financial products area in particular -- and that those efforts will have lasting and beneficial effects.

Healthcare Reform

Let me turn next to our work on implementing the Affordable Care Act (ACA). Unlike much of the rest of the Internal Revenue Code, most of the tax provisions of the ACA do not stand alone – they are integral components of a broader framework for expanding and improving access to health care coverage. Moreover, while the core provisions of the ACA, relating to the health care Exchanges, take effect in 2014, many other key tax-related provisions were either immediately effective or come online before 2014.

To ensure the smooth implementation of these provisions, we and IRS have adapted our guidance process in several significant respects. The first was to establish internal mechanisms to ensure coordination of the work of different groups within our offices. Implementing the ACA has required an unprecedented degree of collaboration among our TLC and BTC staffs – and even our ITC staff in some instances – and the same has been true for their counterparts in Chief Counsel. To coordinate this work, the IRS established a new position of Health Care Counsel, held by Cathy Livingston, and Helen Morrison has been serving in a parallel role for the Office of Tax Policy. Thanks to their efforts, we have been able to publish timely, comprehensive guidance on a wide range of subjects, including the small business health care credit, insurance market reforms, charitable hospitals, the premium tax credit and employer-provided health care coverage.

Second, and reflecting the role of the ACA's tax provisions in the broader framework, our work has required an unprecedented degree of collaboration with other agencies, principally the Department of Health and Human Services and the Department of Labor. In part this is due to the significant number of "three-agency provisions" that are replicated in the Internal Revenue Code and other statutes subject to the jurisdiction of those other agencies, such as the Public Health Service Act and the Employee Retirement Income Security Act (ERISA). These require "three agency regulations" to implement – guidance that is developed and published jointly by Treasury, HHS and Labor. Examples include our guidance on individual and group market reforms, such as the prohibitions on lifetime and annual limits, coverage for dependents up to age 26, rescission, the prohibition on denial of coverage for pre-existing conditions, and our guidance on plan summaries of benefits and conditions.

In addition, significant pieces of guidance that we and IRS have issued independently under the Code has been developed in close coordination with either or both of HHS and Labor, and in some cases published simultaneously with companion guidance issued by those other agencies. Last summer, for example, we issued proposed regulations under section 36B, the premium tax credit, which is designed to help middle-income families that don't have access to affordable employer-provided health coverage to purchase coverage on one of the new health insurance Exchanges beginning in 2014. Determining eligibility for advance payments of the credit – to fund monthly premium payments -- is one of the core functions of the Exchanges. Moreover, one of the key determinants of eligibility for the credit, modified adjusted gross income, will also be used to determine Medicaid eligibility beginning in 2014. Reflecting its integral role in this broader infrastructure, our proposed regulations under section 36B were extensively coordinated with HHS and published simultaneously with a series of HHS regulations providing details on the structure and the operation of the Exchanges and reforms to the Medicaid eligibility rules. We expect to finalize those regulations this year.

And lastly, reflecting again the interdisciplinary and innovative nature of the ACA, we have made frequent use throughout this process of notices that request comments even before we develop proposed regulations. This approach has proved invaluable in helping us to anticipate the questions we need to address and to formulate practical and effective guidance that minimizes administrative burden. A recent example is Notice 2011-36, issued in the spring of last year, requesting comments on a proposed approach for defining full-time employees for purposes of the tax provisions relating to employer-sponsored coverage. We expect to publish further guidance on that subject later this plan year that will build on the very helpful comments we received.

With the health care Exchanges coming on line in 2014, ACA implementation will continue to be a top priority for us throughout 2012. I am confident that we and our IRS colleagues have established a solid foundation to ensure that happens smoothly and effectively, and I am also hopeful that some of the lessons we have learned from this work – about ways to coordinate our own efforts and to seek input from other agencies and stakeholders – can help us more generally to improve the guidance process.

FATCA

Finally, let me turn to FATCA, or more specifically, new sections 1471 through 1474 of the Internal Revenue Code – the core provisions of the Foreign Account Tax Compliance Act. While a significant number of new international provisions – many of them Administration budget proposals – have been enacted over the past three years, FATCA implementation has required the most attention from our international team. And after many months of work and a series of three preliminary notices, I am pleased to say that our proposed regulations are in the final stages of clearance at Treasury and IRS.

In many respects, however, our work has only just begun. We are keenly aware that FATCA imposes significant new requirements and responsibilities on foreign financial institutions. We have received extensive input from the financial community and from practitioners – including the Tax Section – on the challenges posed by these new requirements, and many useful suggestions on how to implement them. As a result, we believe that significant progress has been made over the past year, such that FATCA can in fact be implemented in a manner that is not overly burdensome, when compared to its benefits, and that it can over time serve as a complement and a catalyst to the ongoing global efforts to combat offshore tax evasion.

It is important to recall that FATCA came about as the result of a series of events in 2008 and 2009 involving very serious instances of offshore tax evasion. Earlier this month, the IRS released statistics on its 2009 and 2011 Offshore Voluntary Disclosure Programs that provide some indication of the magnitude of the problem: Together, those programs have resulted in collections of $4.4 billion so far, a number that will continue to grow as the 2011 cases are processed.

This situation arose despite a substantial overhaul during the late 1990s of the regulations on information reporting and nonresident withholding, and the launch of the Qualified Intermediary program by the IRS in 2001. While those earlier efforts were quite successful in improving compliance by nonresident investors, the events of 2008 and 2009 made clear that significant gaps remained in the system – in particular with regard to the reporting of foreign source income earned by U.S. persons from offshore accounts, and the identification of U.S. owners of foreign entities. It also became clear that some U.S. investors had exploited those gaps to hide income and assets offshore.

Across the tax system, voluntary compliance rates are the highest where there is third-party reporting, but this reporting was largely absent for U.S.-owned offshore accounts. Moreover, identifying U.S. taxpayers who earn foreign source income through offshore accounts would require the cooperation of foreign financial institutions, and the existing statutory framework did not provide the government with sufficient tools to achieve that result.

In May of 2009, therefore, the Administration proposed in its 2010 Budget a series of legislative reforms that would have increased the responsibilities of Qualified Intermediaries to identify and report on U.S. accountholders, and established new incentives for foreign financial institutions to become QIs – for example, by imposing withholding on a broad range of U.S. source payments made to non-Qualified Intermediaries. As the legislative process then evolved over the following months, those proposals formed the basis for development of the provisions that were ultimately enacted as FATCA in March of 2010.

Broadly speaking, FATCA has three core elements -- enhanced due diligence, broader information reporting and potential withholding on U.S. source payments. FATCA requires that foreign financial institutions enter into an agreement – which we refer to as an FFI agreement -- with the Internal Revenue Service, pursuant to which the financial institution agrees to:

1. Perform due diligence to identify financial accounts of U.S. persons and of foreign entities with significant U.S. ownership;
2. To report certain information about its U.S. accounts annually to the IRS;
3. To close any U.S. account if the account holder refuses to waive foreign legal protections that would otherwise prevent reporting; and
4. To withhold on certain "passthru payments" that the foreign financial institution makes to "recalcitrant" account holders and to other foreign financial institutions that have not entered into FFI agreements.

If a foreign financial institution does not enter into an FFI agreement, or fails to comply with its terms, U.S. financial institutions are required to withhold U.S. tax at a 30 percent rate from the gross amount of a broad range of U.S. source payments to the financial institution and the gross proceeds from its sales of certain U.S. securities.

Fundamentally, the purpose of FATCA is to obtain information reporting on U.S.-owned offshore accounts. The withholding requirements incorporated in FATCA are not intended to raise revenue. Ideally, every foreign financial institution would comply with the reporting requirements, and no foreign financial institution would be subject to withholding tax. But to achieve this objective, we must address two challenges.

The first is administrative burden. Understandably, both financial institutions and foreign governments have expressed concerns about the burdens imposed by FATCA, relative to what they perceive as the potential benefits. In response, we have sought from the beginning to minimize burden to the extent we can, consistent with the objective of combating the use of offshore accounts to evade U.S. tax. We understand that compliance with any new reporting or withholding requirements requires lead time for financial institutions to reconfigure their computer systems, adjust their procedures, and inform their customers. We recognize that the industry has much to contribute, and we welcome ideas for achieving a smooth transition.

Towards that end, the proposed regulations build upon our prior Notices in seeking to further minimize the administrative burden of FATCA and better focus its application on circumstances that present a higher risk of tax evasion. We have examined again the appropriate standards for due diligence review of pre-existing accounts, and we have set a higher dollar threshold and a more limited scope for manual review of individual account records. For pre-existing entity accounts, the regulations focus review on passive investment entities with significant account balances and permit substantial reliance on documentation previously collected during account opening procedures. Here too, we are proposing a higher threshold for further investigation into potential U.S. ownership. And for new accounts, both individual and entity-owned, the proposed regulations seek to align, to the extent we can, the review required for FATCA purposes with the procedures that financial institutions already follow to comply with anti-money laundering and know-your-customer rules.

To further focus the FATCA implementation efforts on higher-risk institutions, we have expanded the categories of financial institutions that are "deemed compliant" with FATCA, as well as the previously announced exception for retirement plans. And in recognition that global financial institutions face a variety of obstacles in bringing all of their affiliates into compliance, the proposed regulations will provide temporary relief from the requirement that all members of an affiliated group be participating or deemed compliant FFIs.

In order to provide sufficient lead time to develop reporting and withholding systems, the proposed regulations will phase in the FATCA reporting requirements, as well as the rules relating to passthru payments, gradually, over an extended transition period. We believe that these proposals will substantially address the many comments we have already received regarding administrative burden, and will do so in a manner consistent with ensuring that the underlying objectives of FATCA are met.

However, we recognize that this is an ongoing process, and we look forward to continuing our work with all of you on these important administrative issues.

A second challenge presented by FATCA is that certain of its key components conflict, to varying degrees, with privacy or other laws in many countries. In some countries, for example, financial institutions may be unable – under their country's existing laws -- to comply with the core requirement that they report customer information directly to the IRS. The requirement to withhold on passthru payments presents a similar challenge.

To address this set of issues, foreign governments could make changes to their own internal laws to accommodate FATCA reporting (as was done in the case of the Qualified Intermediary program). Alternatively, we have indicated that we are open to exploring an intergovernmental approach to FATCA implementation that would address legal impediments to direct reporting.

To that end, Treasury's international team has already begun conversations with a number of our major trading partners about bilateral approaches to overcome legal impediments and facilitate compliance. A key element of these efforts has been to explore the possibility that financial institutions of a particular country could report the information required by FATCA to their home country government, which would then transmit the information to the IRS, in order to overcome legal obstacles to direct reporting.   The United States already has a network of agreements providing for tax information exchange with more than 60 countries -- whether as part of an income tax treaty or in the form of a specialized Tax Information Exchange Agreement -- and the laws of those countries already permit the transmission of U.S. account information, like that required by FATCA, from the foreign government to the IRS. We believe that building on these existing arrangements for government-to-government exchange of information will be mutually beneficial and will help to ensure that FATCA operates in its intended manner.

At the same time, we recognize that bilateral solutions require reciprocity. In that regard, Treasury and IRS issued proposed regulations last year that would require U.S. banks to report to the IRS on bank deposit interest paid to nonresident account holders. These proposed regulations have been an item of much discussion within some sectors of the financial industry, and indeed they have a difficult history of having been proposed, revised and then withdrawn by prior Administrations. I would emphasize, however, three points: First, information regarding bank deposit interest is already available to the IRS upon request under existing law. The proposed regulations would simply ensure that the IRS has this information on hand when they need to provide it to another government. Second, the IRS cannot provide this information to another government unless the United States has an information exchange agreement already in effect with that other government. Those agreements are designed specifically to ensure that proper care is taken to safeguard confidential information and to limit its use to legitimate tax enforcement purposes. And third, we see no principled basis on which to require that financial institutions based in other countries collect and provide us with information on U.S. taxpayers, if we take the position that our own institutions should be exempt from similar requirements. To the contrary, we believe that it will be critical to the success of our efforts to implement FATCA that we are able to reciprocate.

Implementing FATCA, however, cannot be the end of the story. Ultimately, we believe that our efforts to implement FATCA and to resolve the challenges it poses can and should advance the important work already begun by the OECD and the European Union to develop multilateral, global approaches to the exchange of financial account information for tax purposes. Although this is clearly a longer-term goal, we would hope that the agreements we hope to reach with other governments on bilateral mechanisms for implementing FATCA can serve as precursors to a more comprehensive multilateral approach to information exchange. For that reason, we believe that FATCA – if implemented appropriately – can serve as a catalyst for further advances in the global effort to improve transparency and combat tax evasion.

We believe that our optimism in this regard is justified in view of the very significant progress that has been made just in the last couple of years on facilitating global exchange of information.

First, 105 jurisdictions, the European Union and nine observers are now participating in the Global Forum on Transparency and Exchange of Information, which was organized in 2009 in response to a call by the leaders of the G-20 for the implementation of international standards for transparency and information exchange in tax matters. The Global Forum has undertaken a collaborative effort to peer review the legal rules and information exchange relationships of member countries to ensure that they meet these international standards, as laid out in the OECD Model agreements and commentary. The United States has been an active participant in the Global Forum, and Treasury’s Office of Tax Policy, the Office of General Counsel and IRS Chief Counsel have devoted substantial resources over the past two years, both to the peer review of the U.S. rules and procedures and to our role as members of the Steering Group and Peer Review Group of the Forum. And with the support of the G20, this process has produced meaningful change. Since the Global Forum was organized in 2009, 81 peer reviews have been launched, 59 peer review reports have been completed and published, and more than 700 agreements that provide for the exchange of tax information in accordance with the international standard have been signed throughout the world.

Second, I would draw your attention to the OECD Treaty Relief and Compliance Enhancement project. The TRACE project, which is based loosely on the U.S. Qualified Intermediary program, began five years ago as an effort to improve the ability of portfolio investors to claim withholding relief at source. Facilitating that relief remains the primary focus of the project, but the participating countries and the financial community have also recognized the importance of improving tax compliance as part of that effort. Significant progress has been made in crafting a multi-jurisdictional system that relies on payee-specific reporting, coupled with automatic exchange of information. The TRACE Information Technology group has done considerable work in that regard, and this work is proving valuable more generally in developing information exchange systems. The TRACE system would also help address the concerns of the business community by providing standardized reporting across multiple source countries, a key objective of financial institutions. Work is ongoing in the OECD to develop and promote adoption of the system.

And third, the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters – to which the United States is a signatory -- was recently amended to reflect the current international standard and to allow countries that are not members of the OECD or the Council of Europe to join. Recent signatories include Brazil, Argentina and Japan, and others including China and India are expected to join soon. This is a development that we welcome and strongly support. In the near term, we expect that the Multilateral Convention will meaningfully expand the number of countries with whom we can work to implement government-to-government reporting under FATCA. Over the longer term, we hope and expect that it can become a global system for exchange of information. And we believe that our work with other governments and with the financial community to implement FATCA can inform and advance that long-term goal.

In conclusion, let me just say that, given the substantial body of work we have been able to complete in these three top priority areas, it almost seems remarkable that we have managed to publish anything else. And yet of course we have – as I mentioned at the start, 150 guidance projects in the last six months alone, across a broad spectrum of domestic and international issues. This is to the credit of the extremely talented and dedicated group of lawyers on the Tax Policy staff, who are the ones to make all of this happen. And on a personal note, I would like to take the opportunity to single out one of them in particular – Jeff van Hove, who many of you know, left Treasury last week for the private sector after four years of government service. Last year at this time, Jeff participated in this conference on his first day as our official Tax Legislative Counsel, and he was instrumental to the guidance process throughout his time at Treasury. Our accomplishments on financial crisis, economic recovery and health care guidance owe a great deal to Jeff, and he will be greatly missed. I am very pleased to announce, however, that Lisa Zarlenga – who is currently our Deputy Tax Legislative Counsel for Regulatory Affairs -- will soon replace Jeff as our new Tax Legislative Counsel, and we are looking forward to another productive year.

Thank you.

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