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Summaries for the 32nd Annual TEI-SJSU High Tech Tax Institute

Authors

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Summaries for the 32nd Annual TEI-SJSU High Tech Tax Institute

Held on November 7th and 8th at Crowne Plaza Cabana, Palo Alto, California

Authors: Amin, Saqib; Chen, Silin; Ding, Ophelia; Hemachandran, Veena; San Pedro de Kornsand, Elle; Yalamarthi, Padmini; and Zheng, Yu.

Final § 385 Regulations: Impacts on Debt / Equity Rules

By Saqib Amin, CPA, MST Student

A panel discussed the Final §385 Regulations: Impacts on Debt / Equity Rules. Speakers consisted of Nate Giesselman of Skadden, Arps, Slate, Meagher & Flom LLP, Jill Harding of Alvarez & Marsal, Jimmy Man of Deloitte Tax LLP, Eric Ryan of DLA Piper, and Jay Singer of McDermott Will & Emery. Neil J Young of OANDA moderated the panel.

The discussion started with an introduction to the recently enacted final regulations, followed by an explanation of the documentation requirements, compliance issues, recharacterization rules of the regulations, and concluded with some examples.

Introduction to the Final Regulations

The final §385 regulations, which were issued on October 13, 2016, did not change the basic definition or concepts of debt or equity. The regulations target larger companies that are more likely to have related-party debt that decreases their U.S. taxable income through interest deductions taken on payments made to their non-U.S. based related companies. There are approximately 6,300 large taxpayers and the recharacterization rules under these final regulations will likely affect approximately 1,200 taxpayers when they go into effect for tax years ending on or after January 19, 2017. The final regulation's documentation rules (to be discussed later) apply to debt instruments issued on or after January 1, 2018. These are very targeted regulations, but tax professionals should be familiar with these rules as they may apply in M&A situations.

The Proposed Regulations

In April 2016, the IRS issued proposed regulations to §385. These proposed regulations had two themes:

1. Documentation: If an instrument was not documented as debt, it will be treated as equity. This requirement was one of the 13 factors, originally developed under case and common law (which was the only source for guidance in this area since 1983), that is elevated to one of the key decision-making factors¹. There was no mention of the remaining 12 factors in the proposed regulations.
2. Abusive transactions: Certain transactions (those that erode the tax base), are considered abusive if they are undertaken without a commercial purpose. These are primarily related to inversions.

The above themes appeared broadly in the proposed regulations, including its applicability the pass-through entities. The Treasury received extensive comments from the public stating that if the objective of the proposed regulations is to prevent base erosion, the regulations should target taxable entities only.

Mr. Ryan said that “the Treasury had done a fine job in terms of going through the notices and comments process after issuing proposed regulations.” Considering the comments and feedbacks on the proposed regulations received by the IRS, the final regulations include the following changes:²

- The final regulations do not apply to debt issued by foreign issuers, S corporations, and non-controlled RICs and REITs.
- The final regulations softened the documentation requirements in some situations, such as in cash pooling arrangements.
- The final regulations eliminated the Bifurcation Rule contained in the proposed regulations that would have allowed the IRS to treat debt instruments as part debt, part stock based on facts and circumstances.

¹ *Hardman v. U.S.*, 60 AFTR 2d-87-5651 (9th Cir.) 1987.

² Giesselman, N., Harding, J., Man, J., Ryan E., Singer, J., & Young N. (2016). *Final Section 385 Regulations: Impacts on Debt/Equity Rules*. The 32nd Annual TEI-SJSU High Tech Tax Institute. Conference Presentation. Retrieved from <http://www.sjsu.edu/taxinstitute/2016materials/Sec385.pdf>

Documentation Requirements in the Final Regulations

The core of the discussion focused on the documentation rules of the final regulations. The IRS wants to see spontaneous documentation on third party debt transactions. Documentation should be in place at the time of the debt issuance, especially in material transactions, such as IP migration or supply chain restructuring. The new documentation requirements apply to publicly traded, non-exempt companies with assets in excess of \$100 million or revenue in excess of \$50 million. It was noted that the documentation requirements are the minimum requirements. Besides having the appropriate loan agreement in place at the appropriate time, it is important that the substance of the loans documents matches the true debt form of the transaction, and the interest payments are made per the terms of the loan agreement.

The Expanded Group Instrument (EGI) must satisfy the documentation requirements to be treated as debt.³ Failure to satisfy this requirement will result in a classification of the issuance as stock. The stock could be characterized as common or preferred based on terms and conditions of the instrument.

The final regulations provide an exception from the per se treatment of “highly compliant” corporate taxpayers if there are sufficient common law factors present to treat the instruments as debt. To qualify as “highly compliant,” taxpayers must meet a number of tests set forth by the regulations.⁴ In other words, if a “highly compliant” taxpayer failed the documentation requirements for EGIs, there is a possibility for the EGIs to not be re-characterized as stock. However, the taxpayer should strive to meet the documentation requirements and not rely on this exception as it is much easier to comply with the documentation requirements.

The documentation rules generally require the following items that are commonly present in third-party transaction, including:⁵

1. There must be written documentation establishing that the issuer has entered into an unconditional and legally binding obligation to pay fixed or determinable amount on demand or at one or more fixed dates.⁶
2. There must be written documentation establishing that the creditor has the right to enforce the obligation. The rights of a creditor typically include the right to cause or trigger a default or acceleration of payment in case of non-payment of interest or principal when rights of the creditor are superior to the rights of shareholders to receive assets of the issuer in case of dissolution, and provisions applicable to nonrecourse obligations. The creditor’s rights may be provided either in the legal agreements that contain the terms of the EGI or under local law.⁷
3. There must be written documentation containing information establishing that, as of the date of issuance of the applicable interest and taking into account all relevant circumstances, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations for repayment pursuant to the terms of the applicable interest. There are documentation requirements applicable to nonrecourse EGIs.⁸ An annual credit analysis can be used to support the reasonable expectation that the issuer has the ability to repay multiple EGIs, provided any such EGIs are issued on any day within the 12-month period beginning on the date the analysis in the annual credit analysis is based on

³ Reg. §1.385-2

⁴ Reg. §1.385-2(b)(2)

⁵ Giesselman, N., Harding, J., Man, J., Ryan E., Singer, J., & Young N. (2016). *Final Section 385 Regulations: Impacts on Debt/Equity Rules*. The 32nd Annual TEI-SJSU High Tech Tax Institute. Conference Presentation. Retrieved from <http://www.sjsu.edu/taxinstitute/2016materials/Sec385.pdf>

⁶ Reg. §1.385-2(c)(2)(i)

⁷ Reg. §1.385-2(c)(2)(ii)

⁸ Reg. §1.385-2(c)(2)(iii)(A)

(an analysis date).⁹ A credit analysis must be prepared at the time of the debt issuance. Additional documentation is required for a material event, such as a Chapter 11 bankruptcy of the issuer.¹⁰

4. There must be written documentation evidencing a debtor-creditor relationship with respect to payments of principal and interest. The documentation must include the evidence of payments made by the issuer.¹¹ In the event of a payment default, there must be written documentation evidencing the holder's reasonable exercise of the diligence and judgment of a creditor, or holder's decision to refrain from pursuing any actions to enforce payment.¹²

The final regulations apply the market standard safe harbor rules for the documentation requirement.¹³ There is not a specific IRS form that can be used to satisfy the documentation requirement. The IRS expects documents similar to what is typically present in third party debt instruments.

Recharacterization Rules of the Final Regulations

Under the general recharacterization rules, a debt instrument is treated as stock in the case of certain prohibited transactions. For example, “the distribution of a debt instrument to another expanded group member as a dividend, in exchange for stock of an expanded group member, or in exchange for assets in certain tax-free reorganizations.”¹⁴

Under the funding rule, “a covered debt instrument is recharacterized as stock if the principal purpose of the transaction is a distribution of a property by funded member to another member, an acquisition of expanded group member’s stock, or certain acquisition of expanded group member’s property. The Per se rule treats a covered debt instrument as funding a prohibited transaction if it is issued within 36 months of prohibited transaction”.¹⁵

The final regulation provides for certain exclusions for “the subsidiary stock acquisition, compensatory stock acquisition and the potential iterative application of the funding rule”.¹⁵ The expanding group earning and profits reduction rule provides that “the expanded group earnings of a covered member do not include earnings and profits accumulated by the covered member in any taxable year ending before April 5, 2016”.¹⁶ There is also a threshold exception “for first \$50 million of debt that would have otherwise be recharacterized as stock”.¹⁷

The documentation rules with respect to disregarded entities are modified in final regulation to be in conformity with the general re-characterization rules.¹⁸ Under the anti-abuse rules, “if a member of an expanded group has a transaction with a principal purpose to avoid the re-characterization rules, the debt instrument is automatically characterized as stock.”¹⁹

⁹ Reg. §1.385-2(c)(2)(iii)(B)(1)

¹⁰ Reg. §1.385-2(c)(2)(iii)(B)(2)

¹¹ Reg. §1.385-2(c)(2)(iv)(A)

¹² Reg. §1.385-2(c)(2)(iv)(B)

¹³ Reg. §1.385-2(c)(1)(ii)

¹⁴ & ¹⁵ Giesselman, N., Harding, J., Man, J., Ryan E., Singer, J., & Young N. (2016). *Final Section 385 Regulations: Impacts on Debt/Equity Rules*. The 32nd Annual TEI-SJSU High Tech Tax Institute. Conference Presentation. Retrieved from <http://www.sjsu.edu/taxinstitute/2016materials/Sec385.pdf>

¹⁵ Reg. §1.385-3(c)(2)

¹⁶ Reg. §1.385-3(c)(2)

¹⁷ Reg. §1.385-3(c)(4)

¹⁸ Reg. §1.385-2

¹⁹ Reg. §1.385-3(b)(4)

Conclusion

In conclusion, with the final regulations domestic C corporations that are publicly traded, with revenues greater than \$50 million, or with assets over \$100 million, need to carefully analyze debt issued by related corporations. If this size threshold is met, multinationals need to take the appropriate action plan that include a risk analysis, process development, and control setting to properly evaluate the guidelines of the new regulations to their purported debt transaction. Overall, this is a significant compliance burden that requires appropriate resources.

The Latest Developments within the Large Business and International Division of the IRS: Organizational Restructuring and Changes in Approaches to Examinations

By: Silin Chen, *MST Student*

Representatives from the IRS, public accounting and law firms discussed and explained some of the latest developments within the Large Business and International (LB&I) Division of the IRS – including restructuring and examination approaches. The speakers included Pat Chaback from Ernst & Young, Kimberly Edwards, Tony Shabazz and Gloria Sullivan from the IRS, Larry Langdon from Mayer Brown LLP and Jean A. Pawlow from McDermott Will & Emory LLP. This article will focus on the examination and enforcement processes of the LB&I Division.

The Examination Process

IRS Publication 5125 provides details of the notable changes made to the LB&I examination process. The IRS is moving toward an issued-based approach to conducting the examinations proficiently. Issue managers will be assigned to the technical examination teams to oversee specific issues. Such an issue-based approach requires transparency and collaboration. Therefore, the IRS encourages taxpayers and practitioners to work with them to ensure an efficient examination process. The IRS updated IRM 4.46 with these changes on March 15, 2016.

The issue-driven process is a key element of this new approach. It ensures examination proficiency and the efficient use of resources. The IRS hopes to solve the long-term problem of limited resources with this new approach, but it may result in longer audit periods. To economically use their resources, the IRS will assign agents with expertise in specific areas to the examination. Mentors will also be assigned to the agents to transfer skills and knowledge. If the audited company is geographically far from the IRS, agents may visit the taxpayer's place of business in person or work remotely. Fortunately, audited companies are often willing to travel to the IRS offices to expedite the process.

When there is a claim for refund, the taxpayer should inform the IRS examination team as soon as possible. The IRS must identify the issue early and assess the risks. To facilitate the process, the taxpayer must meet the standards provided by Treasury Regulation Section 301.6402-2 for all claims of refunds. As an overview, there are three phases of an IRS examination: the planning phase, the execution phase, and the resolution phase. The planning phase determines the scope of the audit. The LB&I exam team prepares an audit plan, with an agreement reached with the taxpayer that contains the "issues identified, audit steps, timeline(s), and communication agreements".¹ The execution phase uses an issue-team approach to build the team. The team can use its members' collective knowledge and experiences to gather important information, determine the facts, and fully comprehend the tax implications of the issues. The resolution phase emphasizes the use of resolution tools, such as the Fast Track Settlement program, to reach an agreement between the IRS and the taxpayer. This will be conducted at the team level.

In addition, the IRS will provide extensive employee training to better prepare its employees for examinations. Furthermore, the IRS encourages taxpayers and practitioners to visit their website for commonly asked questions and answers. From there taxpayers can post their additional questions and an IRS team will respond to help with certain terms or areas.

The Enforcement Process

¹ IRS. *Publication 5125: Large Business & International Examination Process*. (2016). Retrieved from <https://www.irs.gov/pub/irs-utl/p5125.pdf>

The IRS will start with an examination with proving the taxpayer (or the taxpayer's authorized representative, if applicable) with Form 4564, Information Document Request (IDR) to request information and documents from the taxpayer during the audit. If the taxpayer fails to respond to the IDR, the IRS will continue the process with three steps: a Delinquency Notice (Letter 5077), a Pre-Summons Letter (Letter 5078), and a Summons.²

The IRS will discuss the issues with the taxpayer to determine the necessary and relevant information required for the audit before issuing the IDR. The IDR must clearly state the issues under examination and only request the information that is relevant. However, this requirement does not apply to the initial IDRs requests general information about on the taxpayer's business.

As mentioned previously, if the taxpayer fails to respond to the IDR, the Delinquency Notice (Letter 5077) is issued. It must be signed by the IRS Team Manager within 10 days of the application of the Enforcement Process. The taxpayer must respond generally no more than 10 business days from the date of the Delinquency Notice. If taxpayer fails to do so, the Pre-Summons Letter (Letter 5078) will be issued, no later than 10 business after the response due date of the Delinquency Notice. Lastly, the IRS will consider the summons procedure when there is a lack of response from the taxpayer to the Pre-Summons Letter.³ A summons is not self-enforcing and is rarely used. The IRS will attempt to have discussions with the taxpayer to find out the reasons for the lack of responses before moving on to the next step in the enforcement process.

Summary

Overall, the IRS encourages increased collaborations between the Service and taxpayers to better understand the taxpayers' positions and provide a more efficient examination environment. "It is a new journey", Kimberly Edwards mentioned several times during the two days this LB&I topic was covered.

² IRM 4.45.4.4.

³ The summons procedures are provided in IRM 25.5

Transfer Pricing Updates

Ophelia Ding, *MST Student*

A panel of experts from accounting and law firms discussed the relevance of several transfer pricing court cases in 2016 with regards to tax planning, practice, valuation, and litigation strategies. Additionally, the panel also addressed the development on the new Section 482 regulations and updates on recent transfer pricing controversies.

Overview on Transfer Pricing

Globalization has increased the number of corporations operating in multiple tax jurisdictions. To economically manage their resources, large corporations use multinational structures to set up foreign subsidiaries under different tax jurisdictions performing various functions of their overall business. For example, it is typical to find that a U.S. corporation will have different subsidiaries in various countries performing part or all of the R&D, manufacturing, sales, and administration functions of its affiliated group. This multinational structuring of a group of corporations under common control creates complex tax issues such as double taxation or, more prevalently, tax avoidance. Consequently, tax authorities typically monitor the transactions between these controlled corporations to ensure that profits are accurately allocated between the related group of corporations under the group's *transfer pricing*. The *arm's length principle* adopted by both the IRS and the Organisation for Economic Co-operation and Development (OECD) attempts to measure the value of the controlled transactions between related parties "as if" they were transactions between independent and unrelated third parties.

To address transfer pricing, the *Internal Revenue Code* provides the IRS with the broad authority to allocate gross income, deduction, credits, or allowance between affiliated members to clearly reflect the income of the taxpayers.¹ The controlled taxpayer must use the arm's length standard to determine the true taxable income from the related party transactions.² That is, treating the related party transactions as if they were transactions between unrelated parties at arm's length using methods that will bring forth the most reliable measure of a result.³

The regulations related to IRC Section 482 provide several transactional and profit-based methodologies for determining the true taxable income of the controlled corporations when intra-group transactions exist. The transactional-based methods include the Comparable Uncontrolled Price (CUP) method, Comparable Uncontrolled Transaction (CUT) method, cost plus method, and the Resale Price Method (RPM). The profit-based methods include the Comparable Profit Method (CPM) and other profit split methods. Taxpayers can also use other unspecified methods that can "provide the most reliable measure of an arm's length result under the principles of the best method rule."⁴

The *Comparable Uncontrolled Transaction (CUT) Method* is the most commonly used method for pricing sales of tangible property. It determines the arm's length price by referencing the price paid in an uncontrolled transaction as a comparable third-party transaction.⁵ The *Comparable Profits Method (CPM)* is the most prevalent transfer pricing method used by taxpayers for intercompany services and sales of intangible property. It determines the arm's length price by referencing the objective operating profit earned by uncontrolled, comparable third parties engaging in similar business activities.⁶

¹ IRC Section 482

² Reg. Section 1.482-1(b)(1)

³ Reg. Section 1.482-1(c)(1)

⁴ Reg. Sections 1.482-3(e) and 1.482-4(d)

⁵ Reg. Section 1.482-4(c)

⁶ Reg. Section 1.482-5

Aggregation of Transactions by Fred Chilton, Managing Director, KPMG Silicon Valley

Mr. Chilton discussed two transfer pricing cases related to Section 482 adjustments decided by the Tax Court in 2016. The taxpayers in both cases have very similar fact patterns and international structures. Both taxpayers' U.S. parents license their foreign subsidiaries to manufacture pacemakers. The foreign subsidiaries then sell the finished pacemakers to the U.S. parent.

First and foremost, when making any adjustments for intercompany transactions, the IRS must use the most appropriate method to calculate the arm's length result under the circumstances.⁷ The controlled transactions in these two cases involved related products or services.⁸ Since the transactions were so interrelated, the IRS decided to consider the combined effect by aggregating the transactions.⁹ Therefore, it stated that the most reliable means to determine arm's length is to make the transfer pricing adjustments to the aggregated intercompany transactions, in accordance with the regulations.¹⁰ The taxpayers disagreed with the IRS and argued that the adjustments should be made to separate transactions instead.

1. Guidant.¹¹

In *Guidant*, the IRS aggregated the controlled transactions and made the Section 482 adjustments to the combined income of the affiliated group. The taxpayer stated that the adjustment made by the IRS was "unreasonable, arbitrary and capricious as a matter of law" because the aggregated transactions did not reflect the true *separate taxable income (STI)* of each controlled member. As required by the regulations, the true STI should be determined if the taxpayer filed separate US income tax returns for each of its members.¹²

The IRS argued that the regulations permitted aggregating transactions if it provides the most reliable means of determining arm's length consideration for the controlled transactions. The Tax Court agreed with the IRS that the controlled transactions of the taxpayer were so interrelated that it was more reliable to measure them as a whole by aggregating the transactions. Therefore, the true STI of each controlled member is not required. The Tax Court further opined that the sole purpose of the STI is "an accounting construct devised as an interim step in computing a group's *consolidated taxable income (CTI)*"¹³ and the essence of the consolidated returns principle is to "levy tax according to the true net income."¹⁴ In other words, the determination of the true net income is most significant aspect of the adjustment. STI and CTI are both constructs to provide the true net income. The IRS and the taxpayer must use the one methodology that better reflects the reality of the taxpayer's business. Moreover, Guidant was not able to provide reliable, specific data of its separate members to satisfy the documentation requirement on their proposed adjustment that was based on the STI.

2. Medtronic.¹⁵

Similar to *Guidant*, in *Medtronic* the IRS made Section 482 adjustments to the aggregated transactions of controlled members of the consolidated group using the Comparable Profit Method (CPM). Like Guidant, Medtronic also argued that IRS's adjustments were "unreasonable, arbitrary and capricious as a matter of law." The taxpayer assumed the burden of proof to show that their proposed Comparable

⁷ Reg. Section 1.482-1(b)(2)(ii)

⁸ Reg. § 1.6038A-3(c)(7)(vii) provides that related products service means grouping of products and types of services that reflect reasonable accounting, marketing, or other business practices within the industries in which the related group operates.

⁹ Reg. § 1.482-1(f)(2)(i)

¹⁰ Reg. § 1.482-1(f)(2)

¹¹ *Guidant LLC, et al. v. Commissioner*, 146 TC 60 (2/29/2016).

¹² Reg. § 1.482-1(f)(1)(iv)

¹³ *Cf. United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 836 (2001).

¹⁴ *Atl. CityElec. Co. v. Commissioner*, 288 U.S. 152, 154. (1933).

¹⁵ *Medtronic, Inc. and Consolidated Subs. v. Comm.*, TC Memo 2016-112. (06/09/2016)

Uncontrolled Transaction (CUT) method better satisfied the arm's length standard set forth by the regulations. The Tax Court agreed with the taxpayer that the CUT Method was the most appropriate method because the foreign subsidiary had independent functions and issues from the parent. Thus, aggregating transactions between the corporations was not a more reliable means of determining arm's length. The Section 482 adjustments should be made to the separate transactions instead of the aggregated transactions.

The Tax Court ruled differently in each case despite the similarities shared by the taxpayers. In *Guidant*, the Tax Court affirmed the IRS's decision on making the transfer pricing adjustments to the aggregated transactions. In *Medtronic*, the Tax Court sided with the taxpayer that the transfer pricing adjustment should be made to separate transactions. Acknowledging the differences in the rulings, the Tax Court explained that proper transfer pricing is a "question of fact." Mr. Chilton noted the perplexity of this statement as the facts and circumstances in both cases are very similar.

Control Premium Adjustments in Acquisition Platform Contribution Transactions by Matt Kramer, Counsel – Skadden, Arps, Slate, Meagher & Flom LLP

The panel continued with a discussion, presented by Mr. Matt Kramer, on control premium adjustments in acquisition of the Platform Contribution Transactions (PCT).

In PCTs, the *acquisition premium* is the difference between the fair market value (FMV) and the acquisition price of the company. A PCT acquisition transfers control between parties.¹⁶ *Control*, in the context of PCT, is "the ability to direct corporation actions, select management, decide the amount of distribution, rearrange the corporation's capital structure and decide whether to liquidate, merge or sell assets."¹⁷ As control is directly tied to the value of the business involved in the PCT, a portion or all of the acquisition premium is attributed to it. On that account, should the value of the PCT payment be reduced by the amount of acquisition premium attributable to the control premium calculated under the Acquisition Price Method (APM)? Mr. Kramer presented arguments from others on both sides as discussed below.

PCT Payments Should *Not* be Adjusted for Control Premium

In most acquisitions, sellers would always want to get a higher selling price. In his whitepaper, *Best Practices Regarding Control Premiums*, Eric Nath¹⁸ opined that "every seller has an opportunity cost which a buyer must overcome."¹⁹ He also argued that arm's length parties do not pay a premium for control. Alternatively, the premium paid in an acquisition is attributed to the law of supply and demand. Simply put, a control premium simply does not exist. Hence, PCT payments should not be adjusted for control premiums.

In addition, a control premium provides benefits to both the acquiring party and the cost sharing participant(s). Thus, it is merely a payment for the intangible assets, and should not be adjusted from the PCT payment.

¹⁶ *Control* in the context of control premium does not refer to the "control" within the meaning of IRC Section 482.

¹⁷ Philip Morris Inc. v. Comm'r., 96 TC 606 (1991).

¹⁸ Eric Nath, ASA, is the principal owner of Eric Nath & Associates, LLC in San Francisco, CA.

¹⁹ Nath, Eric W., ASA (2010). Best Practices Regarding Control Premiums: Comments Regarding the Appraisal Foundation's Proposed White Paper on Control Premiums. *Journal of Business Valuation*, 2011(2), 25-30. Retrieved from <http://www.ericnath.com/articles/controlpremiumwhitepaper.pdf>.

PCT Payments *Should* be Adjusted for Control Premium

Contrary arguments suggested that premiums are paid for control. The Tax Court has stated that a control premium is a payment to “induce the shareholders to transfer control of the corporation” and the value attributable to control is “over and above that is attributable to the corporation’s underlying assets.”²⁰ Furthermore, the IRS had also argued that a control premium must be added to the value of the underlying intangible assets to determine the overall value of the company.²¹ Therefore, in a best method analysis, the determination of the acquisition price of the PCT should consider the value of control premiums.

Implications

It is hard to determine if premiums were paid for control in arm’s length transactions. Mr. Kramer argued that even if one were to believe that control premiums do not exist in a fair market, then perhaps the value of the law of supply and demand should be included in the acquisition payment. Additionally, the value of control and intangible assets are so interrelated that control is probably not compensable in a transaction.

The 3M Case by Paul Dau, Counsel - McDermott Will & Emery LLP

Mr. Dau illustrated the issue of *blocked income* by presenting a recent Tax Court petition filed by the 3M Company in 2013.²² As background, blocked income occurs when foreign law restrictions prevent a subsidiary from making payment to its U.S. parent. In the pending case the IRS imputed 3M’s Brazilian subsidiary’s royalties by eliminating the effect of the legal restrictions using the regulations under Section 482.²³ The taxpayer argued that for the regulations of Section 482 to be applicable, the income must be in control of the U.S. taxpayer according to the Supreme Court case of *First Security Bank of Utah*.²⁴

In 1972, the year of the *First Security Bank of Utah* case, the regulation of Section 482 stated that Section 482 only applied if a taxpayer has complete control of the income. Since then, the IRS removed this specific provision from the regulation in 1994.

The validity of current regulations the IRS applied to the case is, as the time of the conference, still being determined through litigation. At issue is whether the IRS can change its regulations to terminate prior case decisions and whether Congress can pass laws to supersede prior rulings of the Tax Court. The 3M case will have a huge implication in the BEPS world as it might grant the local tax authorities the power to override arm’s length results when the intention was to eliminate “abusive” transfer pricing issues.

Controversy Update by Sanford Stark, Partner – Morgan, Lewis & Bockius LLP

As transfer pricing issues make up about 46 percent of the IRS’s Large Business and International (LB&I) Division’s international issues and 71 percent of the potential international dollar amount adjustments, the IRS is increasing its transfer pricing enforcement.²⁵ Following the recent LB&I restructuring in February 2016, the IRS realigned its resources into different subject matter practice areas, including the Treaty and Transfer Pricing Operations Practice Area (TPPO) which oversees and coordinates the progressively expansive transfer pricing audits.

²⁰ Philip Morris Inc. v. Comm’r., 96 TC 606 (1991).

²¹ DHL Corp. v. Comm’r., TC Memo 1998-461(1998).

²² 3M Co. v. Comr., Tax Court Docket No. 005816-13

²³ Reg. Section 1.482-1(h)(2)

²⁴ Comm. v. First Security Bank of Utah et al., 405 U.S. 394 (1972).

²⁵ *Barriers Exist to Properly Evaluating Transfer Pricing Issues*, report of the Treasury Inspector General for Tax Administration, September 28, 2016 (released November 3, 2016)

Conclusion

There are many emerging issues in the practice of transfer pricing. The taxpayers will face multiple issues pertaining to different unresolved transfer pricing matters.

Going forward, will the IRS make transfer pricing adjustments on aggregated or separate transactions? Should PCT payments be adjusted for control premiums? Can the IRS remove provisions from regulations to make previous case laws moot? Will the restructuring of LB&I result in more comprehensive transfer pricing audits?

Keeping all these uncertainties in mind, it is crucial for the taxpayers and practitioners to monitor the development of each area while complying with the sustained increase in transfer pricing requirements.

International High Technology U.S. Tax Current Developments

By: Veena Hemachandran, *MST Student*

Mr. James P. Fuller illustrated the latest developments in international tax during a two-hour presentation, covering topics from §482 regulations to the importance of the revisions to transfer pricing under Base Erosion and Profit Shifting (BEPS). The session was detailed in a comprehensive, 200-page outline.¹ Mr. Fuller, a tax partner in Fenwick & West LLP, is considered one of the top 25 tax advisers in the world and one of the leading advisers for transfer pricing according to *Euromoney*, a business and finance magazine.² This article summarizes two points of interest within Mr. Fuller's session.

The Implications of the European Commission's Recent Actions on the U.S.

Mr. Fuller emphasized the impact of the European Commission (EC) by detailing the topic of European Union (EU) state aid.

For reference, the European Commission is the executive body of the EU, dedicated to the following:

1. Proposing legislation;
2. Enforcing European law;
3. Managing and implementing EU policies and the budget; and
4. Representing the EU outside Europe.³

On August 30, 2016, the EC concluded that Apple Inc. ("Apple") owed €13 billion Euros of unpaid taxes plus interest due to an illegal Advance Pricing Agreements (APA) in effect between Apple and Ireland. Mr. Fuller noted that similar APAs would have appeared to be proper and available to companies which had similar facts to Apple's situation. Apple operated in Ireland through Irish subsidiaries which were taxed as non-residents since they do not meet the management and control requirements prescribed by the Irish tax authorities. This "selective tax treatment" was treated by the EC as state-aid which gave Apple extensively undue tax benefits compared to other businesses.

The U.S. Treasury has disagreed with the EU on their evaluations of state-aid recipient status and related back taxes and penalties against U.S. multinational companies and issued a white paper that specified the following:

1. The EC has departed from prior practice and case law, threatening global tax reform by overreaching its authority;
2. The approach taken by the EC is new and not in conformity with "international norms." Since the new approach was not implemented before, the EC should not seek to recover back taxes for tax years prior to its implementation.
3. If these tax increases in the EU were to take place, tax revenues would shift significantly from the U.S. to Europe since Apple (and similar companies) could claim a foreign tax credit when filing their U.S. income tax returns, thereby diminishing its U.S. tax liability – often on a dollar-for-dollar basis.

Mr. Fuller observed that the EC's rulings against Apple have far-reaching consequences. They not only damage the credibility of APAs with the EU, but also threaten business relations between the EU and the U.S.. He stated that the EC has also targeted treaties between the Netherlands and Japan as well as those in

¹ Available online at: <http://www.sjsu.edu/taxinstitute/2016materials/> (under International High Technology U.S. Current Developments)

² James P. Fuller. (2016). Retrieved December 7, 2016 from Fenwick & West LLP: <https://www.fenwick.com/professionals/pages/jimfuller.aspx>

³ European Commission: Overview. (2017, May 15). Retrieved December 7, 2016 from the European Commission: https://europa.eu/european-union/about-eu/institutions-bodies/european-commission_en

effect in Luxembourg, noting that these treaties are similar to those in effect between the U.S. and the EU. The EC's perspective and rationale in enforcing these particular tax recoveries was not explicitly addressed.

Changes Concerning F Reorganizations

IRC §368(a)(1)(F) defines an F reorganization as a “mere change in identity, form, or place of organization of one corporation.” Since such reorganizations are minor changes, the transactions are treated as tax-free. The Treasury recently issued final regulations concerning these “F reorganizations” by adopting proposed regulations articulated in 2004 as well as some previously issued temporary regulations issued back in 1990. The final regulations⁴ prescribe six requirements (as opposed to four per the 2004 proposed regulations) which must be met for a company restructuring to qualify as an F reorganization:

1. The stock issued by the resulting corporation is issued in exchange for transferor corporation's stock;
2. There is no change in the ownership of the resulting corporation in comparison to the transferor corporation – the same individuals who owned shares of the transferor corporation's stock still own the resulting company's stock;
3. The transferor corporation completely liquidates;
4. Other than a nominal amount of assets held to “facilitate its organization or preserve its existence,” the resulting corporation cannot “hold any property or possess any tax attributes immediately before the transfer;”
5. Property held by a transferor corporation before the transaction cannot be held by a corporation other than the resulting corporation after the reorganization has taken place; and
6. Property held by the resulting corporation after the reorganization generally cannot include property of any corporation other than the transferor corporation.

The Treasury and the IRS also confirmed their view that since F reorganizations involved only one corporation, they did not “resemble sales of assets” and therefore such reorganizations could not use step transaction principles. These principles had been included in the 2004 proposed regulations stating that F reorganizations could, be a step, or series of steps, before, within, or after other organizations that effect more than a mere change, even if the resulting corporation has only a transitory existence following the mere change (Fuller, “F Reorganization in a Bubble,” Sec. 8(a)).

The IRS and the Treasury had previously articulated their view of excluding F reorganizations from step transactions in Rev. Rul. 96-29, 1996-1, C.B. 50 and have now included it in the final regulations.

Conclusion

While this article summarizes only two of the many items Mr. Fuller discussed, it is apparent that keeping abreast of developments in international tax is increasingly important; the tax world is in a flux, with the spotlight shining on increasing numbers of litigated cases. Changes in rulings have the potential to impact the high number of international firms based in the U.S., affecting foreign and U.S. tax burdens and changing corresponding tax planning strategies.

⁴ § 1.368-2

A Global Review of Tax Incentives

By: Elle San Pedro, *MST Student*

Many jurisdictions around the world provide competitive tax incentives to attract research and innovation investments. A distinguished panel of international tax experts discussed developments and practical considerations regarding these R&D, innovation, manufacturing, and other tax incentives in the United States, Europe, and Asia. The session speakers included Kevin Dangers, Partner at EY; Rod Donnelly, Partner at Morgan, Lewis & Bockius, LLP; and Steven Shee, Vice President, Global Tax and Government Relations at SanDisk.

United States

Recent Research Credit Case Decisions

Mr. Dangers presented several cases that provide guidance on research credit issues:

- **Documentation:** *Suder v. Comm.*, T.C. Memo. 2014-201.
Suder dealt with two documentation issues: (1) whether the use of testimony was reasonable in terms of time allocations, and (2) whether there was sufficient documentation in terms of technical uncertainty. Mr. Dangers referred to this case as an example of how to successfully substantiate qualified research expenses (QREs).
- **Funding:** *Geosyntec Consultants, Inc. v. U.S.*, 776 F.3d 1130 (11th Cir., 2015)
Geosyntec provides clarity on funding arrangements that involved intellectual property (IP) rights and financial risks with respect to the research credit. Companies that perform contract R&D should refer to this case for guidance on tax credit eligibility.
- **Prototypes:** *T.G. Missouri v. Comm.*, 133 T.C. 278 (2009).
In *T.G. Missouri*, the Tax Court held that the intention behind the creation of a prototype, and not its subsequent sale or use, determines whether it qualifies for the §174 research and experimental expenditures deduction. There are several currently proposed regulations that have adopted the *T.G. Missouri* holding and provide taxpayer-favorable clarifications on the scope of the §174 rules.
- **Statistical Sampling:** *Bayer Corporation v. U.S.*, (W.D. Pa. pending).
A key issue in *Bayer* was how to determine the appropriate size of a statistical sampling unit. Although this case was not settled at the time of discussion, Mr. Dangers recommended *Bayer* as a case to follow for future developments.

Final Regulations under Section 41 for Internal-Use Software

Recently issued final regulations (T.D. 9786¹) clarify what is considered internal-use software (IUS), provide rules related to dual-function software, and provide guidance regarding the high threshold of innovation standards required for the incremental research expense (R&D) credit. Applicable to tax years ending on or after October 4, 2016², only software with a financial management, human resources management, or business support function is considered primarily internal-use software. To qualify for the research credit, the IUS development efforts must meet a three-part, high threshold of innovation test: the

¹ IRB 2016-42 (442)

² Treas. Reg. § 1.41-4(e)

software must (1) be “innovative,” (2) involve significant economic risk, and (3) cannot be commercially available. “Innovative” is not restricted to new functions. Significant reductions in cost, improvement in speed, or other measurable improvements satisfy the “innovative” component as well.

Mr. Dangers pointed out that the portion of software that allows third-party interactions generally cannot be deemed IUS. For example, if a customer placed an order through a company’s website, the segment of the software that facilitated this interaction would not be considered IUS. However, there is a safe harbor if a company cannot separate the part of the software that interacts with third parties from its back-end systems and at least 10% of the software’s intended use is for third parties, the company can claim 25% of the software development costs as QREs.

Section 199 Manufacturing and Software

In August 2015, the Treasury issued proposed regulations (T.D. 9731³) to clarify that a party which performs activities in a contract manufacturing arrangement is entitled to claim the §199 deduction. As written, the proposed regulations would eliminate the benefits and burdens of ownership test.

The proposed regulations also look to redefine what constitutes manufacturing. Currently, repackaging activity is deemed as a sufficient manufacturing activity to claim the §199 benefit. The Treasury is trying to elevate the definition of manufacturing activity to more than just repackaging.

Mr. Dangers concluded the U.S. updates by discussing implementation issues surrounding software. Software offered online must meet two criteria in order to qualify for the §199 domestic production activities deduction: the software must (1) have a competitor in the marketplace that is similar in terms of features and functionality (“the comparability test”) and (2) have a separate user prompt. Because many companies that offer software exclusively online have the challenge of identifying an equivalent competitor in the marketplace, there are current discussions to replace the comparability test with different criteria.

European Union

Patent Boxes

Mr. Donnelly began the European Union updates with an explanation that several EU countries have “patent boxes,” which are a set of tax laws that provide preferential tax rates, usually between 5%-15%, on income derived from patents. Alternative names for a patent box include “intellectual property box regime,” “innovation box,” and “IP box.” Hungary, Luxembourg, and Spain have a broader set of tax laws known as “innovation boxes,” which provide for lower tax rates on income from non-patented and patented intellectual property (IP) such as designs, copyrights, and models.

Patent boxes encourage the location of both profits and intellectual activity to be in the same country. Generally, the benefit derived from a patent box increases as in-country R&D expenses increase. Whereas taxpayers must sell or create property to qualify for R&D incentives in the United States, taxpayers that have qualifying income from IP can benefit from European patent boxes.

³ IRB 2015-37 (314)

OECD BEPS Action 5 - *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*

In October 2015, the Organization for Economic Cooperation and Development (OECD) released the final report on Base Erosion and Profit Shifting (BEPS) Action 5⁴. The report included minimum requirements that preferential tax regimes, such as IP boxes, must meet so as not to be considered “harmful.” At the time of issuance, none of the IP boxes met these requirements. The United Kingdom and several other countries have since modified their IP boxes to comply with these new standards.

BEPS Action 5 requires that countries meet a substantial activity requirement to avoid being identified as a harmful tax regime. Per the OECD, if a regime provides preferential tax rates, there must be substantial activities by the taxpayer in their country. BEPS Action 5 adopts an IP-based nexus approach in regard to meeting this substantial activity requirement. The IP-based nexus approach requires tracking IP expenditures, IP assets, and IP income. Mr. Donnelly noted that because this method is impractical and would require arbitrary judgments, the OECD decided to allow jurisdictions to follow a product-based nexus approach. Under the new approach, regimes are permitted to track expenditures to products and product families, rather than to individual IP assets.

An Innovation Box as Part of U.S. Tax Reform?

Although academics and economists are still debating whether IP boxes produce benefits or not, U.S. taxpayers continue to lobby Congress to create an IP box. Specifically, companies are petitioning for an IP box to incentivize R&D in the United States and devise a tax-free mechanism to repatriate IP held off-shore.

In 2015, Representatives Charles Boustany (R-LA) and Richard Neal (D-MA) released a discussion draft for an innovation box proposal. Known as the Innovation Promotion Act of 2015, the effective tax rate on profits derived from qualifying IP would be lowered to approximately ten percent through the allowance of a special, large deduction.

Corporate Tax Reform – The Common Consolidated Corporate Tax Base

In an effort to eliminate the exploitation of preferential tax regimes across the European Union, the European Commission re-launched the corporate tax reform initiative known as the Common Consolidated Corporate Tax Base (CCCTB). The CCCTB aims to create a uniform set of rules for determining corporate taxable income in each Member State. This improved version of the CCCTB would focus on two major areas: (1) an agreement on a common tax base and (2) consolidation.

To conclude the EU updates, Mr. Donnelly added that the CCCTB includes an R&D “super-deduction” to incentivize research and innovation in the region. Small start-up companies that opt-in to the CCCTB would be allowed to deduct up to 200% of their R&D costs, subjecting to certain conditions.

Asia

Drawing upon his extensive experience of working in Asia, Mr. Shee imparted advice on how to effectively identify locations for investment and how to negotiate tax incentives in the region.

⁴ OECD (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5- 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241190-en>

Location Screening and Negotiation

Organizations should consider cost-independent items when evaluating a new business location. Although tax considerations are important, there are many qualitative factors to examine before selecting a location for investment. Mr. Shee advised not to negotiate tax incentives until the organization has realistic expectations of committing to the area. He noted that tax incentives are typically considered after a short list has been generated.

Once an organization has decided to invest in a jurisdiction, the relationship dynamics with the local development office change. At this “handshake stage,” the development office becomes an ally to the organization and works to persuade the government to approve their incentive package.

Evolution of the Region

Countries in Asia are experiencing rapid economic growth and are viewing job creation as a way to improve their local workforce. Mr. Shee commented that in the 90s China readily welcomed the creation of jobs to help its workforce improve economically. Today, China is more concerned with the quality of training its workforce will receive and, thus, more selective about the types of jobs brought into the country. In light of this emphasis on advanced skill-building, Mr. Shee advised that organizations should highlight the transfer of knowledge that would occur when formulating their “pitch” to the jurisdiction.

Conclusion

Mr. Shee concluded the session by reminding practitioners to consider U.S. tax rules when negotiating tax incentives. He provided the example of having to decline a seemingly lucrative tax incentive that, if accepted, would have conflicted with U.S. tax laws and subsequently render his firm ineligible for a foreign tax credit in the United States. As a final piece of advice, Mr. Shee suggested paying close attention to earnings and profits, losses, and the depreciable life of overseas assets when evaluating tax incentives and tax planning abroad.

BEPS in Action

By: Padmini Yalamarthy, *MST Student*

This is a summary of a panel discussion on the recent changes stemming from the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) 2015 Final Reports and related recommendations included in their BEPS Action Plan.¹ The discussion was held by the esteemed panel comprising of Jim Carr from KPMG LLP, Cabell Chinnis from Mayer Brown LLP, Gabe Gartner from PwC LLP, Adam Halpern from Fenwick & West LLP, Michael Patton from DLA Piper LLP and Gary Sprague from Baker & McKenzie LLP at the 32nd annual TEI-SJSU High Technology Tax Institute on November 7, 2016. The panel focused on the latest developments to the BEPS project and the significant challenges that these changes may pose, in terms of identifying the risk areas and how to manage them, impact on current business tax structures and future OECD work.

1. Existence of Permanent Establishment

There are several changes being made and adopted as part of the ongoing BEPS project and Mr. Carr highlighted some of the significant developments to Action 7 on Permanent Establishment (PE).²

- a. **Specific Activity Exemptions:** Paragraph 4 of Article 5 of the OECD Model Tax Convention (MTC) provides that a PE status does not arise under specific activity exemptions. Under the current rules, activities that are preparatory or auxiliary in nature do not give rise to a PE. Activities such as maintaining warehouses for storage of goods, display or delivery, maintaining inventory for further processing, and the collection of information are considered preparatory or auxiliary. However, there have been considerable changes in the way businesses are conducting their operations where the activities once considered preparatory and auxiliary are now forming the core of their business activities. This warranted a modification to the current definition of specific activity exemptions from the PE classification.

The Final Report commentary now provides there will be no PE provided that the *overall* activity of the business resulting from the combination of these activities is auxiliary or preparatory in character. For example, an enterprise maintaining a very large warehouse with a significant number of employees for the main purpose of storing and delivering goods owned by the enterprise will in fact be deemed to have a fixed place of business PE as the storage and delivery activities performed through that warehouse constitute an essential part of the enterprise's business – they are not just preparatory or auxiliary in character.³

Another development is the new anti-fragmentation rule which provides that an enterprise must not fragment a cohesive operating business into several small operations in order to argue that each segment is merely engaged in a preparatory or auxiliary activity.

- b. **Dependent Agent PE:** Under the current rules, an agent acting in a Contracting State (country) on behalf of the enterprise who habitually concludes contracts in the name of the enterprise gives rise to a PE in that State in respect to activities undertaken by that agent, unless these activities are preparatory or auxiliary. This rule has been broadened to include activities performed by an agent playing a principal role leading to the conclusion of contracts that are concluding without any material

¹ BEPS 2015 Final Reports, OECD <http://www.oecd.org/tax/beps-2015-final-reports.htm>

² Action 7 - 2015 Final Report, OECD <http://www.oecd.org/tax/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>

³ Section B of Action 7: 2015 Final Report on Preventing the Artificial Avoidance of Permanent Establishment Status

modification. This broadening will now include any kind of direct selling activity, direct marketing, sales negotiations by the agent etc. as activities potentially undertaken in a principal role and may give rise to PE.

- c. Per Mr. Carr's recommendations, businesses should consider the potential impact of the changes to the PE definition and respond to minimize uncertainty as to existence of PE in their business model. The companies must review their business structures, identify whether activities of local operations are likely to create PEs, assess the impact of potential new PEs on compliance costs and potential double taxation situations, etc. Another response to mitigate PE exposure is to convert to a reseller or a limited risk distributor (LRD). LRDs do not create PE. To ensure no PE is created, the reseller entity formed must be a distributor, not an agent. He foresees that advance pricing agreements (APAs) may now become popular in this area to provide international organizations with additional comfort.

2. Transfer Pricing

Mr. Patton continued the discussion focusing on the developments to the Action items 8-10 on aligning transfer-pricing outcomes with value creation. Since 1995, the members of the OECD as well as non-member countries focused on methods of recognizing contracts and not enough on value creation, which resulted in profits being parked in tax-free jurisdictions. The traditional transfer pricing analysis emphasized contractual terms (i.e., form) and not economic substance in areas of equitable ownership of intangibles through cost sharing and allocation of risks.

Post-BEPS, the intellectual property (IP) ownership now will only be recognized if the cost sharing party or the IP company exercises or manages DEMPE functions which include development, enhancement, management, protection or exploitation of the cost shared intangibles. Cash box IP companies will only be entitled to a limited return on capital. Risks are to be allocated consistent to the actual conduct of the parties. Management of the factors affecting the outcome of the risk is critical. The party being assigned a risk must also have the financial ability to bear the risk.

As a consequence, the tax landscape for Principal Operating Companies (POCs) is changing. A major question is how much substance is needed in IP. Country-by-Country (CbC) reporting is now one of the top priorities for multi-national companies with a POC structure to determine how profits line up with the assets or employees of the organization in each country. Looking forward, increasing transparency and the sharing of information between taxing authorities is expected. The evaluation of revised transfer pricing guidelines on intangibles and risk allocation is crucial. APAs are still available to reduce risk in key jurisdictions but in light of the recent state-aid cases, unilateral APAs must be approached with caution.

3. Attribution of Profits

Mr. Sprague also discussed the latest changes to the attribution of profits as a consequence of the changes in the PE and transfer pricing rules. The revised PE guidelines are expected to result in an increase in the number of classified PEs. The lack of clarity on the consequences of such an increase warranted a discussion draft (DD) on profit attribution that was released on July 4, 2016 that applies the PE profit attribution rules to the new PE definitions. This DD has examples on sales focused activity and a few dealings with warehouses.

The essence of the sales-focused activity examples is that profits are attributable to risks assumed or managed in a country by an enterprise and not by the functions undertaken. For example, a sales agent's activity may be deemed to create a PE but there may be no profits attributable to these activities if there is no inventory or credit risk assumed by that agent. In an instance where the agent assumes inventory risk,

profits may be partly attributed. In the case of a travelling sales person who assumes credit risk, inventory risk and use of an asset, profits are attributable to such sales persons. In the case of the warehouses providing services to third parties and warehouses owning goods, profits are attributable to such warehouses for their economic ownership and for the functions provided by them on the premises. In cases of warehouses owned by an enterprise, but operated by unrelated entity, there is no profit attribution to the functions on the premises to such warehouses.

The major issues raised by the examples were the application of risk allocation, identification of significant personnel functions, and approaches in cases of low or nil attribution. The examples are opaque and details of attribution split between an agent and the head office should have been discussed in more detail. In sales oriented PEs, there is a possibility that audits may conclude that 100 percent of the revenues are attributable to the PE. Looking forward, there may be a revised DD with more technical details and a possible “plan B.”

4. Hybrid Rules

Mr. Gartner later covered the hybrid rules. The Final Report on BEPS Action 2 on neutralizing the effect of hybrid mismatch arrangements was released on October 5, 2015. This report addressed hybrid entities and hybrid instruments. This report does not apply to payments made to an entity resident in a no-tax jurisdiction. For example, a hybrid entity in Ireland, which is a no tax jurisdiction, is not included in the scope of this rule. The final report identifies three categories of hybrid mismatches. The first category is where a payment is deductible under the rules of the payer’s jurisdiction but not included in the ordinary income of the payee. The second category is that of a double deduction where a payment is deducted in two different jurisdictions (which is not very common). The third category is the indirect deduction/non-inclusion scenario, where in the payment is deductible under the rules of the payer’s jurisdiction and the income is set-off against a deduction by the payee, thereby creating a mismatch. The OECD realized a mismatch could result when payments are treated differently by resident and branch jurisdictions and released a Discussion Draft on branch mismatch structures on August 22, 2016.

The European Union’s Anti-Tax Avoidance Directive (ATAD) required Member States to adopt hybrid rules by December 31, 2018 with an effective date by January 1, 2019. Under these rules for mismatches between Member States, in a deduction/non inclusion situation, the payer will deny the deduction and in a double deduction case, the Member State in which the payment is sourced will allow the deduction.

5. Treaty Issues

Mr. Adam S Halpern from Fenwick & West LLP discussed Action 6 on preventing inappropriate granting of treaty benefits. The final report on Action 6 requires the countries to include in their treaties with other countries an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Also to be included is a limitation of benefits (Lob) rule, a principal purposes test, or both.

The U.S. is significantly pushing for Action 14 on making dispute resolution mechanisms more effective. This requires that countries implement mutual agreement procedures in their international treaties in good faith and that cases are resolved in a timely manner. As of now, thirty countries have committed to provide for mandatory binding arbitration in their treaties. Notably absent in this list are China, India, Brazil and South Africa. For these countries, the enforcement of arbitration will depend on peer-based monitoring. This will help achieve resolutions when two countries do not have a treaty on reaching agreement.

Another development on upcoming treaties is Action 15 on developing a multilateral instrument (MLI) to modify bilateral tax treaties. The intention is to address the gap between most recent OECD commentary changes and actual treaties in force. A discussion draft was released on May 31, 2016. It is anticipated to have a flexible structure including an opt-in for mandatory binding arbitration. Apart from the BEPS updates, there has been a 2016 update to the U.S. Model Treaty with a lot of significant changes since the 2006 U.S. Model Treaty. These include special tax regimes narrowed down to focus on royalty and interest stripping out of the U.S., a number of provisions relating to expatriated entities, substantially revised LoB rules, and mandatory binding arbitration.

Conclusion

This discussion highlighted the current status of the various BEPS action items and also the proposed changes with discussion drafts in progress. The panel also added their recommendations on the relevant issues that may arise as a consequence of these changes. It was a very technically rich and engaging presentation on one of the hottest topics in the tax community.

Domestic and Multistate Update

By: Yu Zheng, *MST student*

With the rapidly changing taxation environment, staying updated with both federal and state significant developments is vital for taxpayers and practitioners. On November 7 and 8, 2016, at the 32nd Annual TEI-SJSU High Technology Tax Institute, held in Palo Alto, CA, a panel addressed recent tax changes in the Domestic and Multistate Update session. Partners from Grant Thornton, Mr. Jeff Borghino and Ms. Dana Lance, presented key federal and state updates.

Domestic Update

In the first half presentation, Mr. Borghino explained the recent changes in the gain exclusion of Qualified Small Business Stock and addressed updates on filing deadlines, depreciation, and credits.

1) Qualified Small Business Stock (QSBS)

IRC Section 1202 states that the gain from the sale or exchange of QSBS held more than five years can potentially be excluded from taxable income, but only if the shareholder is a non-corporate taxpayer. The temporary 100% exclusion was made permanent by the enactment of the Protecting Americans from Tax Hikes (PATH) Act on December 18, 2015. The exclusion percentage depends on the timeframe of the acquisition of QSBS:

Acquisition Period	Exclusion Percentage
8/11/1993 - 2/17/2009	50%
2/18/2009 - 9/27/2010	75%
9/28/2010 and later	100%

QSBS is stock in a C Corporation originally issued after August 10, 1993, with the following limitations:¹

- The C Corporation was a qualified small business on the issuance date.
- The C Corporation meets active business requirements during substantially all of the taxpayer's holding period. Active business requirement states that at least 80 percent of assets of the eligible corporation are used in the active conduct of one or more qualified trades or business. The Section 1202(e)(3) gives a definition of which kind of businesses are not qualified.
- The stock was acquired through money, property other than stock, or as compensation for services provided to the corporation.²

A qualified small business (QSB) is a domestic C Corporation, which meets the following requirements:

- The aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993, and before the issuance did not exceed \$50,000,000.
- The aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed \$50,000,000, and

¹ Sec. 13113(a) of Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), passed by the 103rd Congress, added Code Sec. 1202, effective for stock issued after 8/10/1993.

² IRC Section 1202(c)

- The corporation agrees to submit specific reports to the IRS and to shareholders as required under Treasury regulations.³

The eligible exclusion of the gain for a non-corporate taxpayer is limited to the greater of \$10,000,000 (reduced by the aggregate amount of eligible gain taken into account for prior taxable years), or 10 times the aggregate adjusted bases of qualified small business stock issued by the corporation, which was disposed by the taxpayer during the taxable year.⁴

By making the potential full exclusion permanent for QSBS, taxpayers and small corporations can better plan for taxes as it relates to investments and in the issuance of corporate stock.

2) Changes in Due Dates for Certain Business Tax Returns

With the passage of the Surface Transportation and Veterans Health Care Choice Act of 2015, a number of Federal tax return due dates have changed for businesses starting for the 2016 tax year. The filing deadline for calendar-year partnerships moved from April 15 to March 15, with a six-month extension to maintain the September 15 extended due date. For calendar-year C corporations, the filing deadline moved from March 15 to April 15. However, C corporations with a June 30 fiscal year end will only have until September 15 to file their tax returns (one less month than calendar year and non-June 30 fiscal year C corporations). At the time of the High-Tech Tax Institute a five-month extension was supposed to apply to calendar-year C corporations under the new statutes. However, with its authority the IRS subsequently increased the time under extension for calendar year C corporations back to the historical six months.⁵ C corporations with a June 30 year-end now can receive a seven-month extension. There is no change for S corporations. A quick summary of the common filing deadlines starting in 2017, for 2016 calendar year returns, are as follows:

- March 15: Partnerships and S Corporations
- April 15: Trusts, Estates, Individuals and C Corporations

Multistate Update

In the second half of the presentation, Ms. Dana Lance focused on the state-level updates in California and other states.

1) California Update

In 2016, the California Franchise Tax Board amended its regulations for market-based sourcing rules on the sales of marketable securities, interest, dividends, and goodwill.⁶ The changes will apply to tax years beginning on or after January 1, 2015, with a retroactive election available to apply the changes to tax years beginning on or after January 1, 2012.

Marketable Securities

Gross receipts from the sale of marketable securities are sourced to the customer's location.⁷

- For an individual customer, the sale is assigned to the customer's billing address.
- For a business entity customer, the sale is assigned to the customer's commercial domicile.

³ IRC Section 1202(d)

⁴ IRC Section 1202(b)(1)

⁵ See: <https://www.irs.gov/uac/rda-2017-02-08-2016-form-7004>

⁶ California Code of Regulations, Title 18, Section 25136-2

⁷ California Code of Regulations, Title 18, Section 25136-2(e)

- Where the billing address or commercial domicile cannot be determined, the location should be reasonably approximated.

Interest

Gross receipts from interest are sourced as follows:

- Interest from investments is assigned to the state where they are managed.
- Interest from loans secured by real property is assigned to the location of that real property.
- Interest from loans not secured by real property is assigned to the location of the borrower.⁸

Dividends and Goodwill

Dividends and goodwill are treated in the same manner as “sales of stock in a corporation or sale of an ownership interest in a pass-through entity.”⁹

- If a majority of the entity's assets is real and/or tangible personal property, the average of the payroll and property factors is used to source receipts from dividends and goodwill.
- If a majority of the entity's assets is intangible property, the rule generally provides for the use of the sales factor to assign the receipts.¹⁰

2) Other State Updates¹¹

Louisiana

Beginning January 1, 2017, the scope of Louisiana's franchise tax base will expand to include all entities classified as corporations for federal purposes. The tax rate had not been decided at the time of the conference.¹²

A single sales factor apportionment and market-based sourcing were adopted in 2016 and are effective for tax years beginning on or after January 1, 2016.

Another big change in Louisiana is sales tax. The Louisiana legislation changed the sales tax rates on tangible personal property (TPP) and certain services from 4% to 5%, effective April 1, 2016 through June 30, 2018. The increase of 1% does not apply to some certain transactions, including food consumption, natural gas, water and electric, prescription drugs, and installation charges on TPP.¹³

Oklahoma

There are significant updates in sales and use taxes in Oklahoma. New legislation, effective November 1, 2016, changed sales and use tax nexus standards by amending and expanding the definition of “maintaining

⁸ California Code of Regulations, Title 18, Section 25136-2(d)(1)(A)2

⁹ California Code of Regulations, Title 18, Section 25136-2(d)(1)(A)1.

¹⁰ Borghino, Jeff & Lance, Dana. *Domestic and Multistate Update*. (2016). Grant Thornton LLP. 32nd Annual TEI-SJSU High Tech Tax Institute. Conference Presentation. & California Code of Regulations, Title 18, Section 25136-2(d)(1)(A)1.a.-b.

¹¹ Excerpts taken from Conference Presentation notes by Borghino, Jeff & Lance, Dana. *Domestic and Multistate Update*. (2016). Grant Thornton LLP. 32nd Annual TEI-SJSU High Tech Tax Institute.

¹² Louisiana Department of Revenue. Updates on 2017 corporate tax on net income computed at the following rates: Four percent on the first \$25,000 of net income; Five percent on the next \$25,000; Six percent on the next \$50,000; Seven percent on the next \$100,000; Eight percent on the excess over \$200,000. See: <http://www.rev.state.la.us/CorporationIncomeAndFranchiseTaxes>

¹³ Louisiana State Legislature, ACT No. 26. 2016 First Extraordinary Session. HOUSE BILL NO. 62. (2016).

a place of business in this state” to include the presence of any person, other than a common carrier, which has substantial nexus in Oklahoma and who:

- Sells similar line of products as the vendor and does so under same or similar business name;
- Uses trademarks, service marks or trade names in Oklahoma that are the same or substantially similar to those used by the vendor;
- Delivers, installs, assembles, or performs maintenance services for the vendor;
- Facilitates the vendor’s delivery of property to customers in Oklahoma by allowing the vendor’s customers to pick up property sold by the vendor at an office, distribution facility, warehouse, storage place or similar place of business maintained by the person in Oklahoma; or
- Conducts any other activities in Oklahoma that are significantly associated with the vendor’s ability to establish and maintain a market in the state.¹⁴

Conclusion

The panel identified several significant U.S. domestic and state updates and analyzed how these developments will affect taxpayers. With the rapid changes in the tax environment and increasing enactments of new tax laws, tax practitioners are facing more challenges in keeping up to date and understanding the new laws. Tax professionals should be aware of and understand these new tax treatments to advise their clients professionally and help them build the appropriate tax strategies.

¹⁴ OKLA. STAT. tit. 68, § 1352.13.a(2) amended by Oklahoma H.B. 2531, Laws 2016 (enacted on May 17, 2016).