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Summaries for the 29th Annual TEI-SJSU High Tech Tax Institute

Authors

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Summaries for the 29th Annual TEI-SJSU High Tech Tax Institute

An annual conference sponsored by the Tax Executives Institute, Inc. and SJSU Lucas Graduate School of Business

November 4 & 5, 2013

Introduction

The High Technology Tax Institute provides a high quality tax education conference that brings together nationally and internationally recognized practitioners and government representatives to provide insights on current high technology tax matters of interest to corporate tax departments, accounting and law firms, the IRS, academics and graduate tax students.

Certain sessions from the 2013 event are summarized in the articles to follow. We encourage you to read these summaries and to visit the High Tech Tax Institute website to view current and past conference materials in greater detail. If you were not able to attend the 2013 Institute, we hope this overview of the topics covered will encourage you to attend a future program.

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IFRS: Steps Toward Convergence and Conversion in 2013

By Alexander Ciak, *MST Student*

Publicly traded companies in over 100 countries, including Brazil, Mexico, and Canada, require use of International Financial Reporting Standards (IFRS) for financial reporting. Both China and India have taken steps to fully adopt IFRS, but the U.S. has continued to rely on accounting principles generally accepted in the United States of America (U.S. GAAP). Since 2007, the U.S. Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) have been taking steps towards both conversion to IFRS and convergence, the alignment of existing U.S. GAAP with IFRS. However, the steps have been slow and muddled in recent years.

In July 2012, the SEC completed the IFRS Work Plan[1], a document expected to give guidance on how the U.S. would approach convergence. Unfortunately, the document fell short of the public's expectations and failed to provide any insight about future steps. At the end of 2013, the 29th Annual High Tech Tax Institute received an IFRS update from Mr. Alan Jones, Partner, PwC and Mr. Eric D. Ryan, Partner, DLA Piper.

The presenters explained that the steps towards both conversion and convergence made limited progress during 2013. The lack of progress can be partially attributed to the partisan gridlock in Washington D.C. and busy agenda of the SEC. In the U.S., IFRS is generally supported by those in favor of free markets, often touted by the Republican Party, so under the Obama administration, convergence has been less of a priority.

Mr. Jones explained that the goal of IFRS is to have principle-based accounting standards, while U.S. GAAP focuses on a rule based approach. Convergence is a tricky issue because U.S. GAAP is conceptually different than IFRS. For example, by converging with IFRS, the U.S. will be required to alter its accounting standards potentially to the detriment of U.S. companies in areas like inventory valuation.

Under U.S. GAAP, U.S. companies are allowed to use the Last-in-First-Out (LIFO) method to value their inventories. By converging with IFRS, U.S. companies would be required to use the First-in-First-Out (FIFO) method. The change from LIFO to FIFO, Mr. Jones explained, could trigger an increase in the amount of taxable income that U.S. companies pay and report.

Mr. Ryan explained that conversion could also impact the §41 R&D credit. Current U.S. tax law allows companies to immediately deduct qualified expenses related to research and development. Under IFRS,

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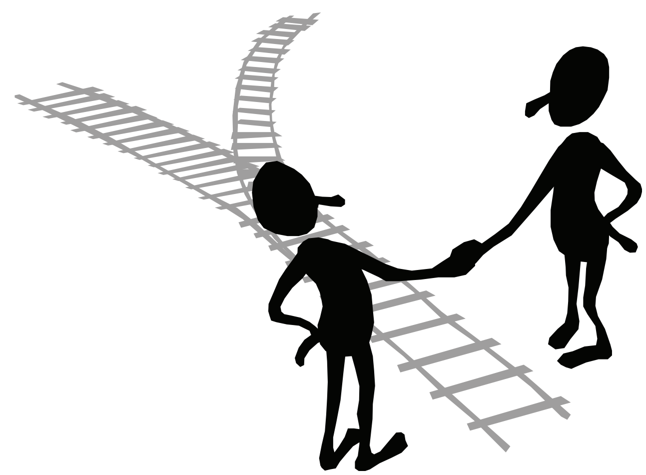
companies may deduct expenses related to research but must capitalize costs related to development. A company claiming the §41 R&D credit under conversion would have to keep its financial reporting in conformity with IFRS, while potentially maintaining a separate record of qualifying development costs for tax reporting.

Despite the problems related to conversion, the speakers emphasized that IFRS is already important for many U.S. companies. When a U.S. company has operations in another country, it most likely already utilizes a form of IFRS for its subsidiaries. Also, mergers and acquisitions related to foreign entities (both inbound and outbound) generally involve some form of conversion to or from IFRS. The presenters also mentioned that potential access to foreign capital markets often requires a U.S. company to submit financial statements prepared using IFRS. The presenters closed by reminding the audience that in a global economy it is important to be accounting bilingual. As U.S. capital markets continue to shrink and cross-border transactions increase, the importance of IFRS to U.S. companies will continue to grow. Thus, the road ahead for conversion is currently stagnant, but as a result of globalization, may pick up steam again sometime in the future.

Alexander Ciak would like to thank Mr. Alan Jones and Mr. Eric Ryan for their assistance in preparing this article.

1 http://www.sec.gov/spotlight/globalaccountingstandards/frs-work-plan-final-report.pdf



Innovation Incentives for Renewable Energy

By Christen Brown, *MST Student*

Innovation incentives, as they are referred to in the accounting industry, are tax credits and refunds that businesses receive in exchange for research and development (R&D) expenditures. According to the Center for American Progress, "Investment in research and development is a significant driver of technological progress and economic growth, particularly in high-wage developed countries."[1]

During the 29th Annual High-Tech Tax Institute, an industry savvy panel comprising of Michael Locascio, Director, Deloitte Tax LLP, Emily Lam, Partner, Skadden, Arps, Slate, Meagher & Flom LLP, Tanya Erbe-German, Senior Director, BDO and Mark Andrus, Partner, Grant Thornton LLP, discussed the following areas of innovation incentives.

- Federal Research & Development credit
- Domestic Production Activities deduction
- State Incentives
- Patent or innovation boxes
- Renewable energy incentives

Since the Silicon Valley is a hotbed of solar and wind power generation, the topic of renewable energy incentives was of particular interest . President Obama's Recovery Act, a plan to double renewable electricity generation by 2020, creates a greater opportunity for business growth. Companies, poised to take advantage of these new incentives, can not only gain tax credits, but also achieve public recognition for promoting the wellness of the environment. Some of the tax incentives currently available to businesses are mentioned below.

1) **Accelerated Depreciation**: Under Section 168(e)(3)(B)(vi), a 5-year recovery period for certain renewable energy property is created. If this method is used under the half-year convention, expenditures will incur a 20% depreciation in Year 1, 32% in Year 2, 19.2% in Year 3, 11.5% in Year 4 and 5.8% in Year 5.

2) **Bonus depreciation**: Under Section 168(k), a one-time depreciation deduction equal to 50% of the adjusted tax basis of certain renewable energy property placed in service before January 1, 2014 is also available. The remaining 50% is recovered through accelerated depreciation.

3) **Production Tax Credit ("PTC"):** Under Section 45, based on the production and sale of electricity over a 10-year period for qualified facilities businesses will receive a credit for construction beginning prior to

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January 1, 2014. These credits are :
- 2.3 cents/kWh in 2013 for wind, closed-loop biomass and geothermal construction or
- 1.1 cents/kWh in 2013 for open-loop biomass, hydropower, landfill gas, trash combustion, marine renewable and hydrokinetic construction.

4) **Investment Tax Credit ("ITC"):** Under Section 48, a credit is available for investment in certain types of energy property. This credit is divided between a 30% and 10% credit :
- 30% for solar, qualified fuel cell (limited to $1,500 per 0.5 kW of capacity), and qualified small wind investments, and
- 10% for qualified micro turbine (limited to $200 per kW of capacity), combined heat and power, and geothermal investments.

5) **Election for ITC In Lieu of PTCs:** Under Section 1102, businesses are able to elect for an ITC in lieu of a PTC (production tax credit), if this returns them a better tax advantage. Businesses are able to claim an ITC for 30% of the adjusted tax basis of property that would otherwise be eligible for PTC.

According to a Recovery Act article, Promoting Clean, Renewable Energy: Investments in Wind and Solar boasts of the programs already in place to promote renewable energy. These measures have produced over $7 billion in tax credits, payments in lieu of credits, and loan guarantees. They have also produced 17,000 jobs across 44 states.[2] Tax incentives for R&D are a critical tool to increase the amount of innovation needed to produce renewable energy. A good accountant will be aware of this fact; but a great accountant will be well apprised on the current tax incentives available for their clients.

[1] The Corporate R&D Tax Credit and U.S. Innovation and Competitiveness Gauging the Economic and Fiscal Effectiveness of the Credit, Tyson, Laura and Linden, Greg, Center for American Progress, January 2012, p. 1

[2] Promoting Clean, Renewable Energy: Investments in Wind and Solar, http://www.whitehouse.gov/recovery/innovations/clean-renewable-energy, Accessed on December 2, 2013.

Presentation of Unrecognized Tax Benefit (UTB) on Financial Statements

By Tejal Shah, *CPA, MST Student*

In July 2013, the Financial Accounting Standards Board (FASB) issued an update regarding the presentation of an Unrecognized Tax Benefit (UTB)[1]. As per the update, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, shall be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward.

The first question that one can ask is the definition of an UTB. UTBs are defined as the different treatment of certain positions on tax returns and financial statements[2]. For example, the tax position of not filing a return in certain jurisdiction (multistate) or change in characterization of income, such as classification of certain income as tax exempt or claiming more credit on tax return than what was eligible. The UTB defers income taxes to future years. Therefore, it creates a deferred tax liability. Fin 48 provides guidance on accounting for these uncertain tax positions.

The main purpose of this article is the presentation of deferred tax liability due to UTB on financial statements, when there is a deferred tax asset created due to NOL carryforward or credit carryforward. Neither US GAAP nor IFRS have explicit guidance on the presentation of UTB. Thus, some entities presented the UTB as a liability, unless it directly resulted in the recognition of net operating loss or tax credit carryforward for that year. Other entities presented UTB as a reduction of a deferred tax asset for a NOL or credit carryforward. The objective of ASU 2013-11 is to eliminate the diversity in practice and streamline the presentation of UTB on financial statements.

Prior to this update, most of the entities used gross presentation: if an uncertain tax position is unrelated to NOL (i.e. does not create or increase a NOL carryforward), but will utilize NOL carryforward to satisfy such liability if due, then both the NOL carryforward and the UTB liability were presented gross in the balance sheet. The only time the UTB liability is reported net of NOL carryforward is the year when such NOL carryforward is utilized to satisfy such liability.

Per ASU 2013-11 update, the financial statement must present UTB, or a portion of UTB liability, as a reduction to a deferred tax asset for a NOL carryforward, a similar tax loss, or a tax credit carryforward[3]. However, if the NOL carryforward, a similar tax loss, or a tax credit

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carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income tax that would result from disallowance of a tax position, UTB shall be presented as a liability in the financial statements[4] (i.e. gross method must be followed). Also, the UTB must be presented as a liability on a financial statement if the tax law of applicable jurisdiction does not require the entity to use the NOL, similar loss, or credit carryforward or the entity does not intend to use the deferred tax asset for such purpose[5].

The following examples might help in understanding the exceptions to net presentation of UTB liability[6]:

a) Different jurisdiction – An entity has a NOL carryforward (deferred tax asset) for the state of CA but the uncertain tax position (UTB liability) pertains to the state of PA. In such cases, UTB liability and the deferred tax asset are presented gross on financial statements.

b) Limitation on use of NOL carryforward in a particular jurisdiction – CA suspended NOL carryover deduction with some exceptions for taxable years beginning 2008, 2009, 2010, and 2011. Thus, the tax position is disallowed and there is a limit on use of NOL carryforward in a particular year, the UTB liability and deferred tax asset must be presented gross on financial statements.

c) Elective treatment – An entity has an option either to use its existing deferred tax asset to settle the UTB liability or pay it off by cash, and the entity expects to cash settle the UTB liability. In such scenario, the UTB liability and the deferred tax assets must be presented gross on financial statements.

Conclusion:

ASU 2013-11 provides guidance on the presentation of unrecognized tax benefit when a NOL, similar tax loss, or credit carryover exists. Its objective is to eliminate diversity in presentation in such situations.

This update is effective for fiscal years and interim periods within those years beginning after December 15, 2013 for public companies and after December 15, 2014 for nonpublic companies. Early adoption is permitted.

This update should be applied prospectively to all UTBs that exist at the effective date. However, retrospective application is permitted.

[1] ASU 2013-11 http://www.fasb.org/cs/ContentServer?pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176163111212

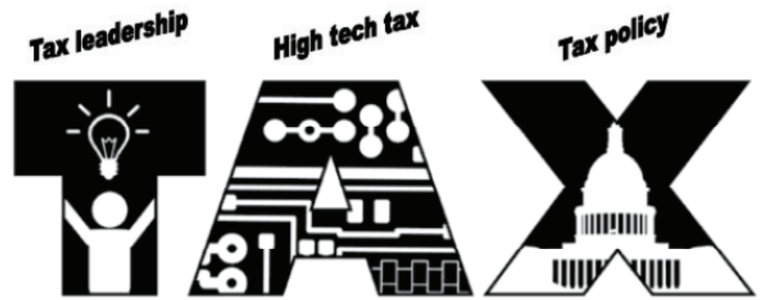
[2] Fin 48, paragraph 17

[3] ASC 740-10-45-10A, ASU 2013-11

[4] ASC 740-10-45-10B, ASU 2013-11

[5] Ibid

[6] Reference taken from presentation on " Accounting for Income Taxes – What's New?" presented by John Hauser, Executive Director – EY, Michael W. Chinn, Partner – PWC, Kelly Gaffaney, Partner – Deloitte and Rusty Thomas, Partner – KPMG at the 29th TEI-SJSU High Tech Tax Institute, November 2013.



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Transfer Pricing: Developments, Surprises, and Challenges

By Ngan Pham, *MST Student*

At the 2013 TEI - SJSU High Tech Tax Institute, Rod Donnelly of Morgan Lewis, with Alpana Saksena of KPMG, Sam Maruca of the IRS and Craig Sharon of EY, discussed issues related to transfer pricing. They provided updates regarding the Organization for Economic Cooperation Development Base Erosion Profit Shifting (OECD BEPS) projects, US Transfer Pricing, and India. Base erosion and profit shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.[1]

OECD BEPS

The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPGs) are targeted for revision. The OECD plans to approve the revision of about 60% of TPGs' chapters from 2014 through 2015. One of the issues they plan to develop and revise, that is pertinent to Silicon Valley, is Action 8 – Intangibles. The goal is to prevent BEPS by moving intangibles among multinational entities.

US Transfer Pricing

The transfer pricing landscape has changed after the IRS moved the former Advanced Pricing Agreement program to the Office of Transfer Pricing Operations, Large Business and International Division (TPO). The TPO has sought out to improve the Advance Pricing Agreement (APA) process and maintain a better relationship with treaty partners. Although optimistic, budget limitations and resources may restrict their progression. In addition, global tax enforcement has a more focused approach on higher-risk transaction related to reputational risk.

India Update

Furthermore, the Advance Pricing Agreement (APA) program with India became operational as of September 2012. India's APA program allows for flexibility in the method for determining arm's length pricing and a timeline of 1 to 3 years for approval. The focus of the India APA team is to agree on a Function Asset Risk (FAR) analysis during which 'site visits' are required. As of March 31, 2013, 158 formal pre-filing APA applications were received by the government and 90% of the pre-filings were converted to applications.

The panel concluded the presentation by reminding the audience that transfer pricing is an evolving subject. As tax practitioners, it is important to track and understand the new developments, so that the element of 'surprise' can be contained.

[1] OECD website http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm

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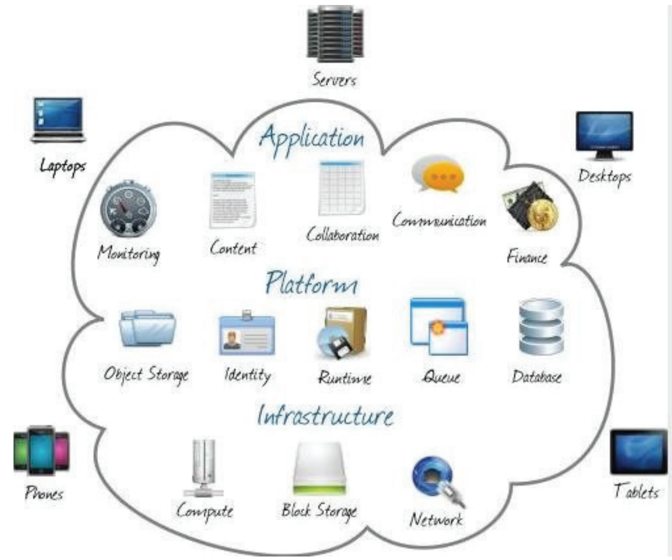
International Tax Implications for Businesses Operating in "The Cloud"

By Kara Virji-Gaidhar, *MST Student*

On November 4, 2013 at the TEI-SJSU High Tech Institute seminar held at Palo Alto, a panel of distinguished international tax experts included Gary Sprague, Managing Partner at Baker & McKenzie, LLP., Kent Wisner, Managing Director at Alvarez & Marsal Taxand LLC., Kimberly M. Reeder, Partner at Reeder Wilson LLP., and Malcolm Ellerbe, Partner at Armanino LLP.

Mr. Wisner began by asking the audience to consider: What is the Cloud ?
The term generally refers to a lack of locally-owned infrastructure where data reside and electronic functions are performed. Instead, this activity takes place over the internet through remotely located servers and at high-speed connectivity. The original categories that comprise the cloud are SaaS (Software as a Service), PaaS (Platform as a Service) and IaaS (Infrastructure as a Service), as illustrated in the following Figure 1:[1].



According to Mr. Ellerby, these categories have rapidly evolved and blended into an array of innovative business models where modern retail transactions occur instantaneously. In this modern paradigm, the instantaneous nature of e commerce becomes problematic because it involves both the definition of logical moments in time where tax relevant events occur, and the determination of what permanent establishment for a taxable nexus means. In e-commerce transactions, determining a tax event is often challenging. Does the incidence of tax occur when a buyer places an order online or when the buyer's credit card is charged ? Does it occur when the seller receives the payment or when the seller delivers the product or when the customer receives the product? Additionally, transactions that occur in "the cloud" involve complexity in pinpointing exactly where the taxable nexus occurs.

Mr. Sprague observed that on the subject of cloud computing, there is limited US tax guidance whereas there are extensive commentaries in Article 5 of the Organization for Economic Cooperation and Development (OECD) Model Convention. For purposes of Article 5, Permanent Establishment is defined as a fixed place of business through which some degree of business of a company occurs.[2] Importantly, Article 7 of the OECD Model Convention sets forth that only profits attributed to a Permanent Establishment will be taxed.[3]

The OECD commentaries provide that a website, by itself is not tangible property and does not give rise to Permanent Establishment. However, a server on which the website is stored, and through which the website is accessed can result in Permanent Establishment because the server constitutes a “fixed place of business”, yet the server location will not give rise to Permanent Establishment when the server functions performed are deemed preparatory or auxiliary to the business. Some activities that are preparatory and auxiliary include advertising of services or goods, gathering market data for the enterprise, and supplying information. To establish Permanent Establishment, a foreign enterprise must own, or lease, and operate the server or data center. Interestingly, a company’s Permanent Establishment may be established interpretively when the functions performed are deemed “essential”, “significant” or “core”. Examples of core functions include a data center hosting a website, holding user data, and engaging in transaction processing.

Mr. Sprague discussed an important ruling that provides guidance with respect to Permanent Establishment to US e-commerce companies doing business in Canada. He discussed the Canadian administrative ruling that involved a US parent company (USP) and its related party, a Canadian subsidiary with a data center[4]. The Canadian ruling addressed the issues of ‘fixed place of business’ and ‘services permanent establishment’. The legal basis for their decision was the US/Canadian tax treaty. Although all server access could be made from the US by employees of the USP, the ruling held that the USP did not have a fixed place of business service Permanent Establishment in Canada because the assets were not owned by the USP, the premises was not at the disposal of the USP, and therefore, the USP did not have a tax nexus in Canada.

The OECD discussions address Permanent Establishment in the e-commerce context from a national or federal governmental view. Mr. Sprague noted that the OECD definition of virtual Permanent Establishment is paralleled in many US states’ tax codes as market-based

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sourcing where selling into a state jurisdiction establishes tax nexus. For example, as it related to sales, California's economic nexus standard is applied under market-based sourcing rules to any taxpayer doing business in California if the taxpayer's sales for the applicable year in the state exceed the lesser of either $500,000, or 25% of the taxpayer's total sales.[5] According to Ms. Reeder, California taxpayers have generally used the Uniform Division of Income for Tax Purposes Act (UDITPA) section 17 cost-of-performance rule, to determine whether or not a sale of services is deemed a California sale for apportionment purposes[6].

There is currently an apparent fundamental US federal tax concept violation. The longstanding premise that income should be taxed where it is created is not being reflected in many state statutes that are allowing for market-based sourcing nexus. Absent sustaining federal tax authority, US states may encounter difficulty to jurisdictionally compel e-commerce companies with virtual Permanent Establishments to pay state taxes. It is critical for businesses and US state regulators to follow the US federal government's response, or lack thereof, to the evolving OECD guidance on Permanent Establishment for taxable nexus in international e-commerce.

1 http://www.crmnext.com/learning/what-is-cloud-computing/

2 OECD Center for Tax Policy and Administration (2012) Article 5 of Model Tax Convention, Permanent Establishment OECD, http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2010_9789264175181-en#page42

3 OECD Center for Tax Policy and Administration (2010) Report on the Attribution of Profits to Permanent Establishment, http://www.oecd.org/ctp/transfer-pricing/45689524.pdf

4 Sprague, Gary D., (2013, May 6) Canada Revenue Agency Issues Important Ruling on PE Aspects of Data Center, International Journal. http://www.bna.com/canada-revenue-agencyn17179873785/

5 Cal. Rev. & Tax Code §23101(b)

6 Cal. Rev. & Tax Code §25136(b)(5) and Cal. Reg. §25136-2

Current International Tax Issues

By: Megan Park, *MST Student*

Globalization today, has made the tax world complex. As companies spread their wings internationally, the tax issues associated with their growth multiply. Current tax developments in the international arena were discussed at length, at the 29th TEI-SJSU High Tech Tax Institute, held on November 4, 2013, at Palo Alto. The esteemed panel comprising of David L. Forst and Adam S. Halpern of Fenwick & West LLP, opened the discussion by presenting the following court case.

FOREIGN TAX CREDITS - Bank of New York Mellon Corp. v. Commissioner

In the case of Bank of New York Mellon Corp. v. Comm., 140 T.C. 2 (2013), the Tax Court held that Bank of New York Mellon (BNY) was not entitled to deduct foreign tax credits and certain business expenses incurred from a Structured Trust Advantaged Repackaged Securities (STARS) transaction due to lack of economic substance. As a result, the taxpayer's foreign partnership structured in a STARS scheme was also disregarded, and the partnership's income was determined as U.S. source income, rather than foreign source income.

The Supreme Court holding in the landmark 1934 Helvering v. Gregory case[1] established the "economic substance doctrine." The courts have applied the doctrine with two prongs: the "economic substance beyond tax benefits" (objective prong) and the "non-tax business purpose" (subjective prong). To evaluate the economic substance of transactions, some courts applied one of these prongs, or both, to determine whether or not a transaction has a lack of economic substance. The Tax Court applied both prongs to the STARS transaction following the legal precedence of Second Circuit, which could be used as the taxpayer's appellate court.

The taxpayer arranged the STARS transaction with Barclays to utilize a "below-market loan" from the U.K. bank. Several entities including a U.K. trust (a partnership for federal tax purposes) complicatedly wove STARS. The taxpayer deducted foreign tax credits and business expenses and reported income generated from the trust, as a foreign source income through this cross-border tax scheme.

Economic substance beyond tax benefits (objective prong)

Despite the Fifth and Eighth Circuits' (appellate courts outside the jurisdiction of this court) determination

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that foreign taxes should not be taken into account in evaluating pre-tax effects for purposes of the economic substance analysis, the Tax Court held that STARS transactions did not have objective economic substance (other than tax avoidance) because it reduced its economic profit due to significant professional service fees and foreign taxes. In other words, the Tax Court also considered foreign taxes in relation to transaction costs. The court also stated that unintended benefits from by-product of taxpayer's transactions should not be considered to determine economic substance and that the circulating cash flows among entities' transactions without any alteration, lacked economic substance.

Non-tax business purpose (subjective prong)

U.S. corporate taxpayers must report worldwide income regardless of paying foreign taxes. In the Goodyear Tire case[2], "Congress enacted the foreign tax credit to alleviate double taxation arising from foreign business operations." The Tax Court states: "The U.K. taxes at issue did not arise from any substantive foreign activity. Indeed, they were produced through pre-arranged circular flows from assets held, controlled and managed within the United States. We conclude that Congress did not intend to provide foreign tax credits for transactions such as STARS." The court further mentioned that "STARS structure lacked any reasonable relationship to the loan. And the loan was not 'low cost.' To the contrary, it was significantly overpriced and required BNY to incur substantially more transaction costs than a similar financing available in the marketplace." Therefore, the taxpayer's true motivation of transactions was tax avoidance, and the taxpayer was not eligible for foreign tax credits. The deductibility of transaction costs arising from the STARS transaction was also denied due to the lack of economic substance of the transactions themselves.

1975 U.S-U.K. Income Tax Treaty

Article 23(3) of the U.S.-U.K. Tax Treaty of 1975 states that "... income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources within that other Contracting State." Per Article 4(1)(a)(i), a partnership or trust is resident of the United Kingdom for the purposes of
U.K. tax, only if its income (including partners' or beneficiaries' portion) is subject to U.K. tax as the income of a resident. Thus, income from the trust (partnership) was foreign source income according to the Treaty. However, the court held the income as U.S. source income and reasoned that "U.S. tax laws and treaties do not recognize sham transactions or transactions that have no economic substance as valid

for tax purposes."
The partnership of the taxpayer passed this test because Barclays clearly had its own economic benefits and had not intended to solely avoid taxes. The court's opinion, however, was not clear regarding the other partner's involvement. Furthermore, the Tax Court did not even mention subchapter K rules regarding the partnership.

The court disregarded the partnership although the partnership was a resident of the U.K. within the meaning of the Treaty and paid U.K. taxes. There might be double taxation issues that are not intended by the income tax treaties.

SUBPART F, Active Rents Exception: Software - FAA 20132702F

The IRS held in FAA 20132702F that a CFC's rental income from the lease of software was foreign personal holding company income (FPHCI, subpart F) and was not qualified for the active leasing exception due to the insufficient marketing functions by the CFC's employees.

Despite limited disclosure of FAA 20132702F, the following facts can be summarized. The taxpayer, a software developer, entered into a cost-sharing agreement with CFC-1. CFC-1 granted CFC-2 rights to distribute copies of the Software to third parties, and CFC-2 was required to return all copies of the Software and all information and had no rights to retain any related materials upon termination.

Reg. §1.861-18(c) provides two classifications regarding transfers of computer programs: a transfer of a copyright and a transfer of a copyrighted article. Reg. §1.861-18(f)(2) further states if the transferee has sufficient benefits and burdens of ownership, the transfer of a copyrighted article constitutes sales or exchange otherwise considered as a lease generating rental income.

CFC-2 was merely given rights to distribute the Software to thirty party customers. The transfer did not constitute a sale or exchange due to insufficient rights transferred. The taxpayer and the IRS both agreed that CFC-2's income from the software license to customers would be classified as a lease generating rental income under Reg. §1.861-18. Thus, the rental income was FPHCI under section

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954(c)(1)(A) unless the taxpayer was qualified for the active leasing exception under section 954(c)(2)(A).

Sec. 954(c)(2)(A) provides exceptions of FPHCI for "rents and royalties derived in active business." Reg. §1.954-2 (b)(6) further states FPHCI "shall not include rents or royalties that are derived in the active conduct of a trade or business." According to Reg. §1.954-2 (c)(1)(iv), rents from property leased to a CFC for marketing functions to generate substantial income for the CFC from the leased property shall be excluded from FPHCI. The taxpayer seemed to qualify for this exception, but the IRS came to a different conclusion.

Reg. §1.954-2(c)(2)(ii) describes "substantiality of foreign organization" when active leasing expenses are 25% or more than the adjusted leasing profit. According to Reg. §1.954-2(c)(2)(iv), the active marketing exception also applies to rents from leases acquired by the CFC lessor, "if following the acquisition the lessor performs active and substantial management, operational, and remarketing functions with respect to the leased property."

A few employees (Executive director, Financial Controller, Software Media Production Assistant) who all had non-marketing backgrounds managed CFC-2. They merely managed CFC-2 regarding administrative (accounting or clerical) matters. The evidence (a few new customers, no time tracking for marketing activities, no bonuses or commissions based on successful marketing) was not enough to prove that CFC-2 actively and regularly engaged in business marketing. CFC-2 was merely a conduit for the payments from third parties. Therefore, the rental income was not eligible for the active marketing exception and classified as FPHCI.

In sum, the active marketing exception to subpart F was particularly applicable to the CFC's engagement in real and substantial marketing business and not for the foreign entity as a mere conduit of payments.

[1] Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

[2] United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 139 (1989)