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The Contemporary Tax Journal Spring 2017

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Letter from the Editors

We are honored to present to you the Spring 2017 edition of The Contemporary Tax Journal.

This issue begins with an article on the Tax Court Examination. Professors Smeal and Ransopher of Georgia State University discuss the obscurity of our current Tax Court examination system and suggested improvements.

Next, in the Tax Enlightenment section, our authors presented various issues facing our current global and local tax environment. Topics include recent California tax developments stemming from the legalization of marijuana, the U.S. tax forms and filing requirements for expatriates, and the country-by-country reporting under BEPS.

Our Tax Feature section summarizes the 32nd Annual TEI-SJSU High Tech Tax Institute Conference held on November 7 and 8, 2016 at Palo Alto, CA. Main topics covered include the recent IRS LB&I examination and reorganization, latest developments in multi-jurisdiction tax including transfer pricing, the new framework for the OECD’s BEPS in Action, a global review of tax incentives, a glance at the §385 final regulations, and an update on domestic and multistate tax issues. If any of the summaries interest you, we encourage you to visit the Tax Institute website for the conference material with more details (http://www.sjsu.edu/taxinstitute/2016materials/).

As part of our mission to serve the tax community, we want our journal to not only cover the recent updates in the tax fields but to help tax professionals at all levels. Therefore, we are excited to announce a new section: CPA Exam Review. This section provides our reader with the latest CPA exam review questions on tax from leading CPA review course providers. We are honored to work with Roger CPA review to present this very first issue of CPA Exam Review. We would like to thank Roger CPA review’s generous support and sincerely hope that this new section will help you achieve CPA exam success.

Remember to check out Student Editor Xuan’s interview with Mr. Gary Sprague, tax partner at Baker & McKenzie LLP, who is a recognized leader in international law and e-commerce law, in the “Tax Maven” section. During the interview, Mr. Sprague passionately shared his career path and advice. We hope his insights and experience will inspire your professional goals.

Last but not least, we want to express our sincere gratitude to Professors Annette Nellen and Joel Busch and webmaster and assistant editor Cathy Dougherty for their continuous guidance and support throughout the tax journal publication process. We also greatly appreciate the efforts of our tremendous authors who took the time to share their observations, perspectives, and knowledge. Your contributions are what made this issue possible.

Enjoy,
Xuan Hong
Ophelia Ding
Student Co-Editors
The Contemporary Tax Journal
May 2017
Bringing the U.S. Tax Court Exam Out of Obscurity

Lucia Nasuti Smeal, J.D. and Tad D Ransopher, J.D.
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1. Introduction

The United States Tax Court is a specialized federal court with jurisdiction over most federal tax controversies. Other federal courts, such as District Courts and the Court of Federal Claims, also can hear tax cases, but the Tax Court is the only court in which a taxpayer can petition for relief from an IRS assessment before payment of the tax liability in dispute.¹ Before 1942, the Court was known as the “U.S. Board of Tax Appeals” where both attorneys and certified public accountants (CPAs) were authorized to practice.² The Revenue Act of 1942 renamed the court the Tax Court of the United States and Board members became known as “judges.”³ The Act also extended tax court practice to those other than CPAs and attorneys.⁴ This provision was codified as Sec. 7452 of the I.R.C. and states, “No qualified person shall be denied admission to practice before the Tax Court because of his failure to be a member of any profession or calling.” However, the Tax Court later adopted a rule that all non-attorneys had to take an admission exam to be able to practice before it.⁵ Attorneys do not have to take an exam and are admitted by application if they are members in good standing of the U.S. Supreme Court Bar, any high court bar, or any state bar association.⁶ The Tax Reform Act of 1969 elevated the Tax Court from an independent agency in the executive branch to an Article I court and renamed it the “United States Tax Court.”⁷

Although CPAs and Enrolled Agents (EAs) already hold a credential which tests tax expertise, the admission exam is no easy undertaking. The exam is a four-hour essay test given every other year and administered only in Washington, D.C. Only a small percentage of candidates pass the test, as discussed below.

Accountants who pass the exam obtain a unique credential, which distinguishes them from their colleagues. Further, they can fully represent their clients without having to refer clients on to tax attorneys with billing rates averaging $400 per hour.⁸ Finally, in many cases adjudicated under the Tax Court Small Case procedure,⁹ taxpayers act as their own representatives, proceeding pro se, presumably because they cannot afford attorneys. The large population of Small Case pro se petitioners could be an untapped client base for non-attorney Tax Court representatives. The issue is whether this potential career path is being communicated effectively to accounting students and whether accounting faculty should do more to inform students about non-attorney admission.

2. Literature review

Few articles outside of the trade press have been written on the issue of Tax Court practice by accountants. The limited coverage in academic literature generally is found in law review articles addressing

¹ Tax Ct. R. 13(a).
³ Revenue Act of 1942, ch. 619, § 504(a), 56 Stat. 798.
⁴ § 139 Revenue Act of 1942, ch. 619, § 504(b), 56 Stat. 957.
⁶ Tax Ct. R. 200(a)(2).
⁹ IRC §7465 authorizes taxpayers with disputes involving $50,000 or less to use simplified small tax case procedures.
unauthorized practice of law by CPAs. For example, a 2012 law review article explores the effect of the unauthorized practice of law rules on CPAs (Smith, 2012). Smith characterizes the Tax Court exam as one “mechanism” that has emerged to allow CPAs to circumvent State unauthorized practice of law (UPL) rules. CPAs who pass the exam may litigate tax cases in the Tax Court which, he notes, is “most certainly” the practice of law (Smith, 2012, p. 388). Smith also points out that CPAs are among the professionals “most profoundly affected by the unauthorized practice of law rules” because accounting services are “inextricably intertwined with the law...” (Smith, 2012, p. 376). Given the nature of tax practice as a multidisciplinary endeavor with elements of accounting, tax, legal, and business services, Smith questions whether the enforcement of UPL rules against CPAs protects the public or only protects attorneys. He concludes that CPAs’ educational and licensing requirements ensure that they are technically proficient, competent, and ethically trained to a sufficient degree to protect the public. Finally, Smith urges that the American Bar Association (ABA) and state bar associations modify their existing rules to allow CPAs an exemption from UPL rules so that CPAs can offer integrated professional services to their clients.10

2.1. Expanded Practice Rights

This call for expanded practice rights for CPAs is echoed in a 2012 study of cases litigated in the Small Case Division of the U.S. Tax Court (Finnegan, Molloy, & Sternburg, 2012). The authors make a policy recommendation that CPAs and Enrolled Agents (EAs) be admitted to Small Case practice in the U.S. Tax Court without having to take the Tax Court exam (Finnegan et al., 2012, p. 40). Their argument for equal treatment with attorneys is based on several key points. First, the authors note that the CPA or EA who prepared the taxpayer’s return is in the best position to present a taxpayer’s claim before the court, both because of familiarity with the taxpayer’s documentation and familiarity with the law (Finnegan et al., 2012, p. 39). In addition, the Finnegan study reveals that the average taxpayer success rate in Small Cases from 2001-2009 was a low 6 percent in winning on all issues, but that this percentage increased to 13 percent if the taxpayer had professional representation (Finnegan et al., 2012, p. 39). Finnegan et al. suggest that taxpayers may have an overall better outcome if they have more access to representation and that the process would be more organized and efficient (Finnegan et al., 2012, p. 40).

A final point made by the Finnegan study is that the Tax Court exam may be unnecessary because it is “duplicative.” The authors observe that CPAs and EAs already have passed “rigorous exams” to test their tax knowledge and go on to state that, “There is no need to require that they take another exam solely for purposes of representing their clients in this informal tax court.” (Finnegan et al., 2012, p. 40).

2.2. Trade and professional publications

Articles in accounting news services and professional journals can be divided into two categories: those that explain Tax Court practice and urge other practitioners to become qualified (Johnson, 2013), and those that give an account of taking the Tax Court exam and offer advice on how to pass (Bell, 2007; Gregory, 2007). Johnson (2013) notes that few non-attorney tax professionals attempt the Tax Court exam and speculates that most are unaware of it. Johnson urges that “...college business professors, accounting firm partners, tax resolution firms and the various professional organizations get the word out to their associates, partners, employees and members” that this opportunity is available.

Sherrill (Gregory) Travato, an Enrolled Agent, U.S. Tax Court authorized practitioner, and author of a Tax Court exam preparation course, urges non-attorneys to take the exam to provide the "highest level of service" to clients (Gregory, 2007, p. 22). She also notes that IRS Appeals Officers will consider hazards of litigation in their assessment of a taxpayer’s case if they know the taxpayer's representative can take a case to the Tax Court (Gregory, 2007, p. 22). Richman (2015) explains that the exam procedures and the pass rates for non-attorneys only recently have been released by the Court (Richman, 2015, p. 1181). He conveys criticism of the exam by CPAs who have taken it but echoes the point that, despite the difficulty of getting admitted, CPAs who have this credential believe it was worth the effort (Richman, 2015, pp. 1182-1184).

3. Rules for admission to practice

The Tax Court rules state that applicants must be of “good moral and professional character and possess the requisite qualifications to provide competent representation before the Court.”11 All non-attorneys must pass an exam to be admitted to practice12 while attorneys do not have to take the exam.13 Both attorneys and non-attorneys must meet the other requirements, which include completing an application and paying a fee of $35. The attorney application is two pages and asks for information on bar admission.14 The non-attorney application is more extensive and requires details of the applicant’s educational background, professional licensing, and a statement as to the specific training and experience which qualifies the applicant to provide competent representation.15 Non-attorneys have the added requirement that two current members of the Tax Court Bar must sponsor them.16

4. Details of the exam

4.1. What is covered

The U.S. Tax Court exam is only offered every other year in even-numbered years in Washington, D.C., so applicants must travel there to take the test. The nonrefundable test fee is $75.

The exam consists of four parts: (1) the Tax Court Rules of Practice and Procedure (25%), (2) substantive Federal tax law (40%), (3) the Federal Rules of Evidence (25%), and (4) legal ethics (10%), including the American Bar Association’s Model Rules of Professional Conduct.17

4.2. Structure and Grading

The examination is a half-day, essay test requiring four hours of continuous writing. Applicants must achieve a grade of at least 70% on each part to pass. According to one exam training center, the total possible score is 960 points, and partial credit is given for partially correct answers.18 The U.S. Tax Court will not confirm the total point score. (personal communication, July 15, 2016). The Tax Court also has indicated that it is up to the examiner whether to give partial credit for a partially correct answer. (personal communication, July 15, 2016).

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11 Tax Ct. R. 200(a)(1).
12 Tax Ct. R. 200(a)(3).
14 http://www.ustaxcourt.gov/forms/Admission_Attorney_Form_30.pdf.
15 https://www.ustaxcourt.gov/forms/Admission_Nonattorney.pdf
16 Tax Ct. R. 200(c).
17 https://www.ustaxcourt.gov/forms/Admission_Nonattorney.pdf
18 http://www.cpatriainingcenter.com/tax_court_exam.asp
4.3. Most frequently tested subjects

Although it is difficult to determine which subjects will be tested on any one exam, the following subject areas have been consistently tested on the 2008-2014 exams:19

Table 1
Most frequently tested areas of 2008-2014 Tax Court exams

<table>
<thead>
<tr>
<th>Exam section</th>
<th>Subject</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Practice and Procedure</td>
<td>General jurisdiction, Discovery, Interrogatories, Petitions, Joinder of issues, Small case procedure, Due process hearing</td>
</tr>
<tr>
<td>Substantive Tax Law</td>
<td>Capital gains v. ordinary income, Deductions, Filing status/penalties, Innocent spouse, Exclusion/inclusion of income</td>
</tr>
<tr>
<td>Federal Rules of Evidence</td>
<td>Impeachment, Business records, Hearsay</td>
</tr>
<tr>
<td>Legal Ethics</td>
<td>Conflict of interest, Attorney as witness, Making false statements of fact or law to tribunal, Offering false evidence</td>
</tr>
</tbody>
</table>

Note that it is commonly believed that the test includes new tax issues from recent Tax Court cases in the substantive tax law and practice and procedures sections. (Bell, 2007; Starkman, 2012; Richman, 2015).

4.4. Details of the 2014 exam

A more in-depth look at the details of the most recent exam reveals the level of difficulty of the test. The 2014 exam contains 73 questions to be answered over four hours, or 240 minutes. This is an average of 3.29 minutes per question. The following is a description of each part:

Part One, Tax Court Rules of Practice and Procedure: This section has 23 questions over 5 pages, and applicants are allotted 60 minutes for completion. Each question has a recommended time limit. For example, Question P-1 is allotted 10 minutes, with one minute allowed for each of the 10 subparts. This is a fast pace to read the question, give an answer, and offer an explanation.

19 Past exams are available for a small copy charge from the U.S. Tax Court.
Part Two, substantive tax law: This section has 31 questions and candidates are allowed 96 minutes for completion. Quick computations are required for some questions. For example, Question S-5 (8 minutes) has 16 subparts where the candidate must give the amount that constitutes gross income to a taxpayer in 16 different scenarios. The suggested time limit is ½ minute for each subpart. Some questions call for a simple answer, such as whether $75 in free donuts from an employer is taxed to the employee in Question S-5(n). Most questions call for a narrative answer, applying the tax rules to brief fact situations. For example, Question S-8 on the 2014 exam gives candidates two minutes to answer the following question:

TP owns residential real property that is TP’s principal residence for income tax purposes. Close to the time TP acquired the real property, TP entered into a loan agreement with TP’s mother in respect of the real property. The loan agreement transaction was commemorated in the “Home Equity Loan Agreement” and the “Home Equity Deed of Trust.” The Home Equity Loan Agreement provides that TP’s interest in the real property is specific security for the payment of the debt. The Home Equity Loan Agreement and the Home Equity Deed of Trust never were recorded in the official records of any jurisdiction. Under applicable state law, an unrecorded mortgage is invalid against third parties who do not have actual notice of it. TP made payments to TP’s mother pursuant to the Home Equity Loan Agreement and claimed a §163(h)(3) qualified residence interest deduction with respect to the payments. Discuss whether TP is entitled to any deduction for §163(h)(3) qualified residence interest.

Part Three, Federal Rules of Evidence: This section contains 10 questions over three pages, and candidates are given 60 minutes or six minutes per question. These questions are longer narratives and represent scenarios where evidence is presented, one of the parties (either the IRS or the taxpayer) objects to the evidence, and the test-taker must answer how the Court should rule.

Part Four, legal ethics: This section of the exam has nine questions and covers 24 minutes. The questions are either two or three minutes in duration and call for “brief” explanations. Some of the questions involve standard ethical issues familiar to accountants and enrolled agents, such as conflicts of interest and clients providing false information, the subject of Circular 230 rules. Other questions test on concepts specific to law practice, such as when a representative can withdraw from representation. Thus, the legal ethics section is new material for non-attorneys that must be well understood to answer some of the more difficult questions on this section of the exam.

Candidates are allowed to use the Tax Court Rules of Practice and Procedure, the Internal Revenue Code, and the ABA Model Rules of Professional Conduct during the exam, but the pace of the test allows little time for looking up answers. No reference material is allowed for the most difficult section for non-attorneys, the Federal Rules of Evidence.

4.5. Grading and getting the results

The exam has evolved over the years, and the procedures for creating it were substantially changed in the mid-1990s when law professors took over from court personnel to create and grade the exam (Richman, 2015). Currently, a three-professor committee makes up the questions and grades the exams. Candidates can obtain a copy of their graded exam for $.50 per page, which shows the number of points they made on each question.20 The Court does not release any model answers to the questions, so candidates have no way of knowing why they lost points or what kind of answers were expected from them (Richman, 2015; Starkman, 2012). This fact is particularly confounding when the exam includes such open-ended questions

20 https://www.ustaxcourt.gov/forms/Admission_Nonattorney.pdf
as S-7 (4 minutes) on the 2014 exam: “Briefly discuss the essential elements of the federal income tax “hobby loss” rules.” The exam instructions give the following guidance as to how the questions should be answered. “Clarity and conciseness of expression will be a significant factor in grading your examination.”

Unsuccessful candidates have 60 days to request a copy of their exam and 90 days to notify the Court of any clerical errors in the grading. The Court also warns candidates that no post-examination hearings, personal interviews, or reexaminations are provided to failing applicants. If a candidate fails, they have to start the process over by submitting a new application to take the exam at the next scheduled date—two years later.

5. Statistics on pass rate

The number of candidates who pass is low, averaging only about 13 percent over the last 15 years. The Tax Court keeps no statistics based on the credentials of the candidates who take the examination, nor does the Court keep statistics regarding the pass rates of different sections of the exam. (personal communication, July 15, 2016.) The pass rates for the 2000 through 2014 exams are listed in the chart below provided by the Tax Court.

Table 2
STATISTICAL INFORMATION: NON-ATTORNEY EXAMINATION

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Examinees</th>
<th>Number Who Passed the Exam</th>
<th>Pass Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>102</td>
<td>17</td>
<td>16.67%</td>
</tr>
<tr>
<td>2002</td>
<td>47</td>
<td>7</td>
<td>14.89%</td>
</tr>
<tr>
<td>2004</td>
<td>72</td>
<td>4</td>
<td>5.56%</td>
</tr>
<tr>
<td>2006</td>
<td>58</td>
<td>6</td>
<td>10.34%</td>
</tr>
<tr>
<td>2008</td>
<td>54</td>
<td>8</td>
<td>14.81%</td>
</tr>
<tr>
<td>2010</td>
<td>83</td>
<td>8</td>
<td>9.64%</td>
</tr>
<tr>
<td>2012</td>
<td>77</td>
<td>11</td>
<td>14.28%</td>
</tr>
<tr>
<td>2014</td>
<td>126</td>
<td>23</td>
<td>18.25%</td>
</tr>
</tbody>
</table>

These numbers show that 619 persons took the test over the period. Of the 619, only 84 passed it, which is an average pass rate of 13.57% for the eight exams given over the period. The reasons for the low pass rate are unclear. It could be because those with no formal training in accounting, tax or law can take it. Another reason may be the testing on a subject foreign to tax practitioners, the rules of evidence. Despite this low pass rate, CPAs should not assume that they cannot pass the exam. Given that CPAs have specialized tax education and have already passed a rigorous professional exam, the pass rate for CPAs is likely to be much higher than that of uncredentialed tax preparers.

The exact number of attorneys versus non-attorneys currently admitted to practice before the Tax Court is difficult to determine. Richman (2015) reports that the Court says there are 250 non-attorneys and some 70,000 attorneys currently admitted to practice (Richman, 2015, p. 1181). He believes a more accurate number is 20,896 total practitioners including attorneys and non-attorneys based on the total number

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21 2014 U.S. Tax Court Non-Attorney Admission Examination.
23 From the numbers released by the Tax Court, there is no way of knowing if the 619 were different individuals or whether any of the examinees were repeating the test.
registered to file electronically (Richman, 2015, p. 1181). It is clear that the number of non-attorneys admitted to practice before the Tax Court is low.

6. Commercial review courses

There are a number of commercial Tax Court exam review courses available to prospective candidates offering either a self-study or live program. The price range is about $750 to $8,500, depending on duration of the course and whether it is live, online, or includes only self-study materials. All of the services offer some kind of comprehensive review. These exam preparation businesses are mostly run by CPAs and Enrolled Agents who were successful in completing the exam themselves. The evidence and legal ethics sections generally are taught by outside attorneys. Despite the availability of comprehensive review courses, most candidates are not successful.

7. Review of textbook coverage of Tax Court exam and non-attorney representation

The most commonly used textbooks in undergraduate and graduate tax courses have little or no mention of the fact that accountants can practice before the Tax Court if they pass an exam. Most of these texts contain basic information on the Tax Court, IRS practice and procedure, and representation of taxpayers before the IRS. If Tax Court practice by accountants is mentioned at all, it is only briefly. Of the nine books identified below, only three include any reference to Tax Court practice by non-attorneys, Pratt & Kulsrud's "Federal Taxation" (2016), Everett, Hennig and Nichols’ "Contemporary Tax Practice" (2013), and Saltzman’s "IRS Practice and Procedure" (2013). A summary of textbook coverage appears below.

In the Spilker et al.'s “Taxation of Individual and Business Entities” (2016) book, there is no reference or discussion of the Tax Court exam or Tax Court practice by accountants.

In the CCH line of tax textbooks, including Smith, Harmelink and Hasselback's “Federal Taxation: Basic Principles” (2016) and "Federal Taxation: Comprehensive Topics" (2016), no references to the Tax Court exam and non-attorney representation are included.

The content of Hoffman, Maloney, Raabe and Young's “South-western Federal Taxation Comprehensive Volume” (2016) tracks other comprehensive tax textbooks, including chapters on IRS practice and procedure, sources of the tax law, tax practice considerations, all logical discussion points for the Tax Court exam. Like other texts, the Hoffman book contains no information on the Tax Court exam.

Pratt & Kulsrud's "Federal Taxation" (2016) includes a brief mention of accountants practicing in the Tax Court. Under Chapter 2, Tax Practice and Research, in the Tax Litigation section, the textbook states, “In most cases, tax litigation is conducted only by licensed attorneys. However, CPAs and others, including the taxpayer himself, can represent the taxpayer in certain situations.” (Pratt and Kulsrud, 2016, p. 2-3). Under the heading, Taxation as a Professional Career (Pratt and Kulsrud, 2016, p. 2-5), the book has the following bullet point: “The tax specialist might represent an individual during the IRS examination or present oral and written arguments before an IRS appeals conference and (if qualified) before the U.S. Tax Court.” The textbook has no discussion of how an accountant becomes qualified to represent taxpayers before the Tax Court.

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25 http://www.ustaxcourt.gov/Non-attorney_Exam_Statistics.pdf Note that review course sponsors give their own statistics on passage by candidates who took their courses.
Of the two tax research textbooks used primarily in graduate accounting programs, only one has a comment on Tax Court practice by non-attorneys. CCH’s book on tax research, Everett, Hennig and Nichols’s “Contemporary Tax Practice” (2013) includes two brief mentions of non-attorney representation in the Tax Court. In Chapter 3, under the subheading of The Regular U.S. Tax Court, the text states, “The taxpayer may be represented by a licensed attorney or an individual who passes a special examination on the rules of evidence for the Tax Court.” (Everett et al., 2013, p. 3005.03). Later in Chapter 3, under the subheading Factors to Consider in Choosing a Court, Other Factors, the text states in the context of a discussion of choice of forum, “The U.S. Tax Court may offer more opportunities for selecting representatives before the Court, as the Small Cases division does not require legal representation and the Tax Court allows individuals other than attorneys to try a case if they have passed a special Tax Court examination.” (Everett et al., 2013, p. 3019.03).


Two other books used primarily in graduate courses on IRS practice and procedure were reviewed for Tax Court exam coverage. In Misey, Goller’s “Federal Taxation, Practice and Procedure” (2014), footnote 31 in Chapter 10 references Tax Court Rule 200, which provides rules for admission, but does not mention non-attorney practice. (Misey et al., 2014, p. 263). Saltzman’s “IRS Practice and Procedure” (2013) includes one sentence on non-attorney practice. In Chapter 1, IRS as an Administrative Agency, when describing the nature of the proceedings in a tax case, the authors state, ”The Tax Court permits the appearance before the court of non-lawyers, who cannot practice before a federal district court.” (Saltzman, 2013, p. 1-55).

8. Why the exam is here to stay

8.1. Rules of evidence and legal ethics

Finnegan et al. make the point that both CPAs and EAs have “already passed rigorous exams which have tested their tax knowledge.” (Finnegan et al., 2012, p. 40) and go on to state, “There is no need to require that they take another exam solely for purposes of representing their clients in this informal [Small Case] tax court.” (Finnegan et al., 2012, p. 40) That may be true, but from a lawyer’s perspective, the rules of evidence and knowledge of legal ethics requirements are central to litigation and the practice of law. The Tax Court exam reflects this position, with 25% of the exam dedicated to the Federal Rules of Evidence and 10% of the exam on legal ethics. The U.S. Tax Court is run by attorneys, and it is implausible that they will change their position on allowing CPAs and EAs to practice before the Court without taking the exam, even in Small Cases. Although the Small Case procedures are more informal and the Tax Court rules allow a judge more discretion in admitting evidence,26 the Tax Court is a court of law and the rules of evidence apply just like in other federal trial courts.

The legal ethics portion of the exam covers ethical issues specific to law practice and representing a client before a court of law. The Court is not likely to allow a representative of a taxpayer to appear before the Court without specific knowledge of these rules. As reported by Richman (2015), Judge John O. Colvin, a former chief judge and former chairman of the Tax Court’s Committee on Admissions, Ethics, and

26 Tax Ct. R. 174(b) states: “Conduct of Trial and Evidence: Trials of small tax cases will be conducted as informally as possible consistent with orderly procedure, and any evidence deemed by the Court to have probative value shall be admissible.”

27 Tax Ct. R. 143.
Discipline, maintains that practitioners representing taxpayers before the Tax Court must have knowledge beyond that of CPAs and EAs. They must also know the Court’s procedural, evidentiary, and ethical rules (Richman, 2015, p. 1182).

8.2. Legislative attempts to waive exams for CPAs

It also is unlikely that Congress will act to dispense with the Tax Court exam in Small Cases. Although there were several attempts in the 1980s and 1990s to revise Section 7463 to allow Small Case practice by CPAs and EAs, those provisions never were enacted (Starkman, 2012). Although there are several bills pending in Congress to change the Small Case procedure in the Tax Court, none of them include a provision to allow CPAs and EAs to practice before the Court without taking the exam.

9. Why a representative of any kind gives a better result

9.1. Case results show need for representation

In a majority of Small Cases, taxpayers have no representation and proceed pro se. The chart below, created from an analysis of Tax Court Summary opinions in RIA Checkpoint, shows that taxpayers were represented in Small Cases only 13.26% of the time over the 15-year period from 2001-2015.

Table 3
Tax Court summary opinions, 2001-2015, with percentage of taxpayer representing themselves indicated

<table>
<thead>
<tr>
<th>Year</th>
<th>Case #</th>
<th>Pro Se</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>189</td>
<td>162</td>
<td>84.18%</td>
</tr>
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<td>82.67%</td>
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Finnegan et al. (2012) compiled data on pro se taxpayers in Small Cases from 2001 through 2009 and found that only 11 percent of taxpayers were represented. (Finnegan et al., 2012, p. 39). Their study reports that only 6 percent of taxpayers who represented themselves in Small Cases won on all issues compared to 13 percent if the taxpayer was represented by counsel (Finnegan et al., 2012, p. 39). Finnegan et. al. speculate that the pro se taxpayers ...“did not understand the merits of their cases or how to properly prepare for their day in court.” (Finnegan et al., 2012, p. 39). It is clear from these data that taxpayers who are represented in Small Cases are more successful. It also is clear that unrepresented taxpayers are at a disadvantage going up against IRS attorneys, who have both tax knowledge and litigation experience.

9.2. Opportunities to dispose of case on preliminary matters

Perhaps the biggest advantage of allowing more CPAs and EAs to represent taxpayers in the Tax Court is that it could greatly increase the ability of taxpayers to resolve cases before litigation. While CPAs and EAs can represent the taxpayer before the IRS Office of Appeals,30 the Appeals Office knows those professionals cannot go before the Tax Court unless they are specially admitted. In evaluating cases, the IRS Appeals Office must consider the hazards of litigation.31 The risks are much higher when taxpayers are represented. Thus, taxpayer appeals may not be as effective if the Appeals officer knows that the taxpayer’s representative cannot take the case any farther.

Once the taxpayer’s case is put before the Court by filing a petition, there is another opportunity to dispose of the case before trial. After filing, the District Counsel and taxpayer exchange documents and start the stipulation process.32 Then, a Branerton Conference33 —a pre-trial conference without the judge--will be held before trial. The Court mandates these pre-trial conferences before it will hear the case. Sometimes the taxpayer can negotiate a settlement at the Branerton stage. For example, the taxpayer’s representative might convince the District Counsel that the case would produce bad precedent, a concept unknown by many taxpayers. At each stage of the process of resolving disputes with the IRS, the parties are encouraged to negotiate and avoid litigation. A taxpayer is in a much better position to prevail or at least obtain a compromise if he or she is represented by a competent tax professional who understands how to navigate and negotiate these preliminary matters. In addition, CPAs and EAs who have prepared the taxpayer’s return or at least reviewed the revenue reports are in the best position to present the documentation necessary to substantiate the taxpayer’s claims (Finnegan et al., 2012) and to articulate favorable law. If a taxpayer has no representation at all, the IRS has much less incentive to negotiate, and the taxpayer is at a disadvantage going up against an attorney on the other side.

In summary, it is clear that taxpayers would be better off with a representative when presenting their cases to the IRS. It also is clear that, for the foreseeable future, CPAs and EAs will not be able to represent taxpayers beyond the Appeals stage if they do not pass the Tax Court exam. Therefore, it is important that something be done to expand the number of CPAs and EAs practicing before the U.S. Tax Court.

10. Conclusions and suggestions

10.1. Conclusions

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31 IRM 8.6, Conference and Settlement Practice.
33 Branerton Corp. v. Commissioner, 64 T.C. 191 (1975).
Despite calls to relax the Tax Court practice rules for non-attorneys, this change is unlikely to happen given that the Tax Court Judges have not shown any intention to do so. Further, attempts to have Congress legislate this change continue to fail. Given that the Tax Court exam will continue to be required, the issue becomes how best to increase the number of accountants eligible to practice before the Tax Court.

Accounting graduates have the potential to practice before the Tax Court and to serve clients that otherwise would not have representation. Textbooks are not effectively communicating this information to accounting students. Therefore, it is up to accounting faculty to inform their students about Tax Court practice by non-attorneys.

10.2. Suggestions for informing accounting students about Tax Court practice

Below are methods that can be used to educate students about the opportunity to serve as a Tax Court representative for their clients.

- Include an explanation of non-attorney representation and the U.S. Tax Court exam in appropriate tax courses.
- Arrange a visit to the Tax Court for students. The U.S. Tax Court sits in numerous cities across the country at different times during the year.34
- Give students a mock Tax Court exam, at least on the substantive tax law questions, to help them become familiar with the test. Note that answers to the questions are not released, so educators will need to formulate their own correct answers.

Both taxpayers and the accounting profession would be well served by increasing taxpayer representation in the U.S. Tax Court. Taxpayers could get better results, and accountants could offer a more full-service practice. The difficulty of the exam and unfamiliarity with some subjects covered should not deter accounting students from attempting to gain this credential. The CPA exam is very rigorous as well and has a low pass rate of less than 50%.35 Including information on the Tax Court exam in college accounting programs would help lead students to this important career path.

34 For a list of cities and dates, see [https://www.ustaxcourt.gov/dpt_cities.htm](https://www.ustaxcourt.gov/dpt_cities.htm).
35 [https://www.aicpa.org/BecomeACPA/CPAExam/PsychometriesandScoring/PassingRates/Pages/default.aspx](https://www.aicpa.org/BecomeACPA/CPAExam/PsychometriesandScoring/PassingRates/Pages/default.aspx)
References


IRS-SJSU SMALL BUSINESS TAX INSTITUTE

Hear from well-regarded practitioners and IRS personnel.
Network with fellow tax practitioners.

WHEN
June 22nd
8:00am – 4:30pm

WHERE
Biltmore Hotel
Santa Clara, CA

REGISTRATION IS OPEN
– DON'T MISS OUT ...
Register and pay online at
http://www.tax-institute.com/

Questions?
Contact Annette Nellen at
annette.nellen@sjsu.edu

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Country by Country Reporting Under BEPS
By: Fenny Lei, MST Student

Background

In the aftermath of sweeping and devastating destruction of World War II across Europe, the Organisation for European Economic Co-operation ("OEEC") was formed in 1948 to manage distribution of post-war aid under the Marshall Plan and encourage economic collaboration through expansion of intra-European trade, improved labor conditions and studies of multilateral transactions. The OEEC, headquartered in Paris, started with 18 participating European countries and then expanded to include countries outside of Europe, evolving into the current, continuously expanding Organisation for Economic Cooperation and Development ("OECD") in 1961. Currently, the OECD has 35 Member countries and five key non-Member partners, bringing together countries that account for 80% of world trade and investment, affording it a unique position in shaping global economic policies. While the OECD has no legal jurisdiction in its participating countries, its main decision-making body is composed of representatives from member countries, thus providing a centralized forum for discussion and dissemination of policy changes. Typically, the OECD monitors developing economic controversies in its member countries and other nonmember countries, pinpoints areas deserving further data collection and analysis and publishes the findings with guidance after multilateral discussion and peer review. The guidance can result in formal agreements and implementation by countries, bringing about binding policy changes such as policies against bribe. This paper focuses on the base erosion and profit shifting ("BEPS") Action Plans published by the OECD, particularly newly required transfer pricing documentation.

An Introduction to BEPS

As global economies march towards more interdependence, leading to high-volume, multi-jurisdictional transactions, international tax complexities and issues have surfaced, specifically BEPS. Simply put, BEPS is a tax-motivated scheme of shifting income of multinational enterprises ("MNEs") from high tax jurisdictions to lower tax jurisdictions, through aggressive tax planning – with an emphasis on strategic transfer pricing. However, not all transfer pricing is purely tax-motivated as it is required in many ordinary transactions of MNEs, resulting in difficulty measuring BEPS quantitatively. Predominantly, researchers focus on mathematical modeling of the relationship between the income of MNE affiliates and various related factors including tax rate differences between the parent and affiliate. If BEPS is present, then the income of MNE affiliate should increase as the MNE parent tax rate increases due to income shifting from parent to affiliate and vice versa. A meta-regression analysis study conducted by Heckemeyer and Overesch concluded a semi-elastic relationship of pre-tax profit to tax of 0.8, which translates into a 1% tax differential between the lower tax jurisdiction affiliate and higher tax jurisdiction parent that would result in a 0.8% increase in the MNE’s profit. There is little doubt BEPS exist, but the scale is largely in question. According to the OECD, BEPS is conservatively estimated to be responsible for annual tax revenue loss of 100 billion USD to 240 billion USD for governments globally, a significant loss for most countries, but especially for developing countries due to their higher reliance on corporate income tax revenue.

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2 OECD Website, Retrieved on May 8, 2017 at: http://www.oecd.org/about/membersandpartners/
Moreover, MNEs like Starbucks, Google, Amazon, and Apple have recently been making headlines due to their astoundingly low effective tax rate on foreign income, subsequently causing public outcry at home and abroad and resulting in BEPS gaining unprecedented political importance. As BEPS became a political priority for many of its members, the OECD strived to implement a framework to combat BEPS and align tax more accurately with the jurisdiction of value-creating economic activities. As a result, the OECD published its final comprehensive BEPS package in 2015 complete with 15 Action Plans, addressing issues of the digital economy, transfer pricing documentation, BEPS analysis and more. In addition, the BEPS package also includes four new minimum standards: stop MNEs from tax treaty shopping for more favorable tax treatments, increase transparency for tax authorities through country by country (“CbC”) reporting, improve dispute resolution and implement peer review process on harmful tax practices.

**CbC Reporting Overview:**

Transfer pricing documentation requirements are diverse depending on the local jurisdiction with some requiring annual reporting or contemporaneous documentation, making compliance and risk assessment difficult. Action Plan 13 proposes a standardized three tier documentation process for transfer pricing:

1. Master file, to provide global tax authorities with an overview of the international business operation and transfer pricing policies.
2. Local file, to provide local tax authorities with details of transfer pricing transactions including information on participants, accounting of the transactions and substantiating documentation related to each transaction.
3. CbC reporting, to provide identification of entities, operating activity, the amount of revenue, income tax accrued and paid, the number of employees, stated capital, retained earnings and tangible assets in an annual report for each pertinent tax jurisdiction.

Together these three documents paint a more standardized, comprehensive picture of transfer pricing activities and aid tax authorities in utilizing effective risk assessment tools to stop the tax-motivated shifting of income activities. Keep in mind the OECD can only issue guidance, standards, and models from which member countries can potentially implement, but are not legally required to follow in detail. Each jurisdiction may end up with slightly different reporting forms and requirements.

**IRS CbC Reporting Guidelines:**

The IRS first issued Proposed Reg. 109822-15 in 2015 addressing CbC reporting guidelines pertinent to U.S. based MNEs and then followed up with a slightly modified final regulation §1.6038-4 as part of T.D. 9773 in 2016 after incorporating some feedback. To maintain consistency, the IRS attempted to minimize the deviation of its CbC reporting guidelines from the OECD model, especially regarding filing obligations and reporting information. Recently, the IRS also released draft Form 8975, the official form for CbC reporting.

**Filing Obligations:**

The CbC reporting is by far the most detailed report required out of the three tiers, but not all U.S. MNEs are required to prepare it. A filing U.S. MNE is:

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8Treas. Reg. §1.6038-4

1. Headed by an ultimate parent entity that indirectly or directly owns a group of business entities required to report as a consolidated group under U.S. GAAP or required to do so if equities in the ultimate parent entity are publicly traded on U.S. stock exchange. The ultimate parent entity also must not be owned directly or indirectly by another entity insofar as required to report under such entity using consolidated accounting under U.S. GAAP. Exception: the ultimate parent entity may assign a controlled U.S. business entity, defined in Section 6038(e), as surrogate parent entity to file on behalf subject to all the same requirements as if the report is filed by the ultimate parent entity.

2. One or more business entities must be liable for taxes levied in another tax jurisdiction outside of U.S. (country or territory with fiscal autonomy including U.S. territories) through incorporation, business operation or permanent establishment. In the context of this regulation, a business entity is:
   a. Any separate business entity recognized for federal tax purposes, not including trusts defined under Treas. Reg. Section 301.7701-4,
   b. Any grantor trust owned in whole or in part by individuals under IRC Section 671,
   c. Disregarded entities under Treas. Reg. Section 301.7701-3,
   d. Any business entity defined as a permanent establishment under tax convention, subject to tax in outside jurisdictions or treated as separate entity by owner’s jurisdiction.

3. Reporting a total annual revenue of equal to or more than 850 million USD in the prior reporting period.

If the U.S. MNE group fulfills all of the above criteria, then the filing obligation applies to U.S. MNE ultimate parent entities whose first day of taxable year begins on or after June 30, 2016 and it is responsible for reporting information on all its business entities for applicable reporting periods on Form 8975 no later than the due date of federal income tax return including extensions, barring any exceptions. However, some constituent business entities may be subject to an earlier applicability date in its local jurisdiction. According to the OECD guidelines, a business entity residing in another jurisdiction different from its ultimate parent entity has an obligation to file in that jurisdiction in accordance with local CbC reporting regulations if its ultimate parent entity does not file CbC reports in its jurisdiction of residence. To address this issue, the IRS released Revenue Procedure 2017-23 outlining filing options and procedures for ultimate parent entities with multi-jurisdictional business entities subject to an earlier local CbC reporting applicability date beginning on or after Jan. 1, 2016. Those qualifying ultimate parent entities may file an amended income tax return with Form 8975 attachment beginning on September 1, 2017, and the filing date must be within 12 months of the end of the taxable year including the early reporting period.

**Reporting Information:**

The ultimate parent entity must report the following administrative and financial information on each of its business entities:

1. Identify the tax residence and incorporation jurisdiction, legal name of entity, main business activities and tax ID assigned by the local tax authority.
2. Revenues generated from business entities transacted both within and outside of the U.S. MNE group, profit/loss before income taxes, taxes paid, withheld, or accrued, stated capital, net book value of tangible assets, and total accumulated earnings. Deferred tax and provisions do not need to be reported if they fall outside of the reporting fiscal year.

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3. The number of full-time or full-time equivalent employees at the end of accounting period. The scope of full-time employees includes independent contractors participating in the ordinary course of business of the business entity and traveling workers, but traveling workers are attributed to the tax jurisdiction of their original business entity of employment and not the tax jurisdiction where work is performed. When reporting, the ultimate parent entity should use applicable financial statements, books, and records of the business entity and other documentation used for regulatory or internal control purposes to furnish information required. However, it is not responsible for reconciling CbC reported information to consolidated financial statements or tax returns. In Action Plan 13, the OECD describes Multilateral Competent Authority Agreements in the context of automatically exchanging CbC reporting information under defined scope, timing, procedures, and safeguards. Similar to OECD guidelines, U.S. CbC reporting information will be shared via an automatic exchange through competent authority arrangements with other jurisdictions through information on possible bilateral and multilateral automatic exchange arrangements.

Implications:

Compliance with BEPS reporting will be challenging because MNEs must prepare CbC reports in each pertinent jurisdiction in accordance with local requirements which can become cumbersome if the MNE has a large network of foreign business entities. Consequently, more resources need to be allocated to data management, training, and personnel recruitment to maintain compliance with various jurisdictional regulatory changes. Moreover, CbC reporting allows tax authorities unprecedented access to global tax data, putting MNEs under more scrutiny.

Conclusion:

Implementation of BEPS Action Plans is rapidly becoming a reality for many countries. As of now, 44 countries have signed the CbC’s Multilateral Competent Authority Agreement on the Exchange of CbC Reports ("MCAA"), agreeing to participate in an automatic exchange of CbC reports amongst themselves. Interestingly, the U.S. is not one of the signatories; instead opting to forge its own automatic exchange channels through bilateral competent agreements and tax treaties with other jurisdictions. As more jurisdictions integrate CbC reporting legislatively, each jurisdiction will most likely deploy CbC reporting standards differently, so it is imperative to monitor the jurisdiction of MNE clients’ business entities and respective jurisdictional CbC regulations to ensure compliance.

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Proposition 64 Legalizes Marijuana in California but the War on Drugs Continues
By: Jessica Wong, MST Student

Introduction

Though the possession and sale of marijuana remain illegal under federal law, there are a few states that will allow legal dispensaries to purchase and sell marijuana to the public. One particular state, California, allows the sale of medical marijuana and has recently approved Proposition 64 (Prop 64). The state’s Legislative Analyst’s Office estimates that state and local revenues generated through state-legal sales of marijuana will potentially increase by over $1 billion annually as a result of the passage of Prop 64. The revenue would be from state excise taxes generated by the growth and sales of cannabis, individuals switching from illegal marijuana purchases to legal purchases from marijuana dispensaries, and an expected increase in the demand for cannabis products. With passage of Prop 64 back in November 2016 and state’s full legalization (beyond medicinal) of marijuana use in 2018, the state of California will have additional ways to collect tax revenue from the sales of cannabis. However, these changes require adjustments from local governments, marijuana dispensaries, and tax practitioners working with marijuana businesses. Despite of the changes in the state’s tax law, the marijuana industry is encountering problems because the US Federal government still considers the possession of the drug to be illegal. This article will analyze the proposed tax changes from Prop 64, its effects on the state and local tax levels, current tax issues from the City of San Jose, problems encountered by marijuana dispensaries, and concerns for tax practitioners who serve this industry.

State Tax Laws Imposed by Prop 64

The sales for all marijuana products in California are subject to the state’s sales and use tax regulations plus potentially any additional taxes enforced by the city where the seller has dispensaries. In the November 2016 election Prop 64 was approved by a popular vote of 57.13%. As a result of the proposition’s passage, marijuana will be legal under state law for recreational use effective on January 1, 2018. With this new proposition taking place tax laws will change in order for the state and local governments to collect additional revenues in the form of taxes on cannabis products. While Prop 64 was still on the ballot, the State Board of Equalization issued a Special Notice regarding how the retail and cultivation sales of marijuana will be taxed. Changes to California’s sales and use tax regulations include the following:

- Effective November 9, 2016, certain sales of medical marijuana are considered tax-exempt for sales/use tax purposes. This sales and use tax exemption applies to the retail sale of cannabis products sold as a prescription. Cannabis products that the patient may purchase are dried marijuana leaf or flower products, edible medical cannabis products, or topical creams. Patients with a prescription and also a valid Medical Marijuana Identification Card (MMIC) are allowed to choose what type of cannabis products to use within the limits of how much cannabis the dispensary will sell them per visit.

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1 See 2016 LAO summary at: http://www.lao.ca.gov/BallotAnalysis/Proposition?number=64&year=2016
2 Ibid
- Effective January 1, 2018, a 15 percent state excise tax applies to all retail sales of cannabis products including marijuana purchased on prescription.

According to California’s current sales and use tax regulations, prescriptions are exempt from sales tax. As such, this special 15 percent excise tax allows the state to collect tax revenue from the gross sales of cannabis despite the general prohibition against sales tax against traditional prescription drugs. In addition, the following state tax on cultivators will apply:

- $9.25 per ounce of dried marijuana flowers
- $2.75 per ounce of dried marijuana leaves

Compared to most marijuana dispensaries, many cultivators do not have a sophisticated accounting system to record their sales. Some cultivators grow and process their crops, then deliver them to dispensaries for sale without issuing or saving sales receipts. Additionally, because the transaction is for a tangible product, the dispensary would not be able to issue an IRS Form 1099-MISC to the cultivator. Therefore, auditing a cultivator will be difficult. Ideally, adding an additional tax on cultivators will generate more revenue for the state, but the problem is the actual collection and enforcement of the tax.

The City of San Jose’s Marijuana Industry Before Prop 64

There are currently 16 dispensaries allowed to legally sell medical marijuana in the City of San Jose. Although the city keeps trying to shut down any illegal dispensaries, it lacks proper resources to close all of them. Additionally, the 16 legal dispensaries are required to send reports of their daily sales to the city. The dispensaries are also required to report and pay their Marijuana Business Tax (MBT) on a monthly basis. This is conducted by requiring the dispensary to connect their point-of-sales (POS) system with the city’s police department. When the dispensary reports its monthly sales, the sales are reported to the city’s finance department which could communicate with the police department to verify monthly sales.

Even for marijuana dispensaries operating illegally in San Jose, they are still required to report their sales and pay their MBT. As of February 2015, there were five marijuana dispensaries that, according to city records, owed a combined amount of over $2.1 million dollars in MBT taxes to the City. One particular dispensary, MediMart, has not only chosen to operate illegally but refused to pay state sales tax as well as San Jose’s MBT.

MediMart opened in 2009 as a nonprofit collective under the entity Bay Pacific Care, Inc. Around May 2012 the business discontinued paying their MBT taxes and filed tax returns indicating that taxes were not owed. The corporation’s president, David Armstrong, argued marijuana is considered illegal under Federal law, and concludes that the tax associated with the sale of the products is illegal itself. The case between the City of San Jose and MediMart is still ongoing.

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6 California Revenue and Taxation Code, Reg 1591(b)
7 IRC Sect. 1.6041-1
9 The list of registered collectives in the city of San Jose can be found at: http://www.sanjoseca.gov/index.aspx?nid=4860
Potential Challenges Cities Encounter with the Enactment of Prop 64

Depending on where dispensaries operate, cities have the authority to impose a MBT based on the gross sales of marijuana. The MBT rate can vary from city to city. For example, San Jose currently imposes an additional ten percent tax to the state’s sales tax for retail sales of marijuana products; whereas, Oakland charges MBT at a rate of five percent. A matter that would add complications to the MBT tax law, is that dispensaries want to implement a delivery service. The cannabis products would be delivered using the dispensary’s vehicles and are not through common carriers. The purpose of this service is to provide convenience for patients who are physically unable to pick up the drug in person.

Though it is currently illegal for dispensaries to deliver products to their customers, Prop 64 will legalize the delivery of cannabis. A potential problem with deliveries for a city is to determine which city has the right to collect the MBT. If a dispensary located in San Jose delivers cannabis products, using its company vehicle, to Oakland, the city of Oakland would be entitled to collecting the MBT. This logic stems from the Bradley-Burns Uniform Local Sales and Use Tax Regulation 1802, where local sales tax is allocated based on the location of sale. Therefore, the city of Oakland will collect the MBT, causing San Jose to lose the tax revenue. Additionally, Oakland charges MBT at a lower tax rate, forcing cities to compete with each other for the collection of the tax.

The enactment of Prop 64 will propose that, under the California’s Sales and Use Tax Regulation 1591, MBT will no longer apply to the sales of medical marijuana after January 1, 2018. So far, the City of San Jose has not made a determination on how the MBT will be collected nor made any changes to their municipal code.

Marijuana Industry’s Lack of Federal Benefits Leads to Problems for State and Local Governments

Under Federal law marijuana is considered an illegal drug. Dispensaries are not allowed to receive any expenditure deduction or credit, “if such trade of business (or the activities which comprise such trade or business) consists of trafficking in controlled substances...which is prohibited by Federal law or the law of any State.” This includes the denial of gross income deductions related to rent, advertising, and salaries. However, taxpayers may deduct expenses that are related to the “return of capital”, such as, the costs of seed, plants and any other costs that can be properly included as cost of goods sold under Federal tax law. A dispensary is still required to file a Federal income tax return, but unlike non-cannabis businesses, it is not allowed to deduct most ordinary and necessary business expenses, which results in the business paying higher taxes.

Despite the fact that it is legal to operate a marijuana dispensary under Federal law, California recognizes a dispensary as a potential legal business. The state has a stand-alone law that allows marijuana dispensaries to deduct expenses, such as, rent, advertising, salaries and other ordinary and necessary expenses on their state tax returns so long as the business is operated as a corporation. Deductions for any necessary business expenses and cost of goods sold may be deducted on a California corporate tax return as long as they are considered necessary for operating

12 San Jose Municipal Code 4.66.250(A)
13 City of Oakland. N.d. City of Oakland Business Tax Classification & Rate Schedule: http://www2.oaklandnet.com/w/0AK024875
14 Article 19. Bradley Burns-Burns Uniform Local Sales and Use Taxes, Reg. 1802(d)
15 IRC §280E
the business under IRC 162. However, if the dispensary is not operated as a corporation (for example, as a sole proprietorship), California does follow the Federal tax rules as it relates to the non-deductibility of all expenses (except for cost of goods sold). Therefore, dispensaries need to consider the differences between California tax laws and Federal tax laws when they decide what form of business entity to operate from and they should save all expense documentation for tax purposes. It is not uncommon for dispensaries to be more concerned with Federal tax laws than state laws. Since dispensaries are denied most federal deductions, they believe that they do not need to save records related to their business. The lack of records from these particular dispensaries makes it incredibly difficult for the state and city authorities to audit these businesses.

Another problem facing both the industry and tax authorities is that there are various Federal laws that may potentially make it illegal for banks and credit unions from accepting any money related to sales of cannabis products as well as providing traditional banking services such as credit card and check processing. As a result, dispensaries are effectively forced to receive payments from customers and pay state and local taxes in cash. However, small community banks may be allowed to work with marijuana dispensaries but will need to comply with the US Treasury and Justice Department to monitor their client's activities. Standards from the US Treasury and Justice Department require these financial institutions to monitor red-flag activities. These red flags require that the banks must monitor the following activities from dispensaries:

- Rapid movement of cash deposits followed by immediate withdrawals.
- Commingling of business funds with the officers' or owners' personal accounts.
- Deposits from third parties that are not related to the business.
- Ensure the dispensaries financial statements are consistent with their banking activities.

The standards from the US Treasury and Justice Department also require financial institutions to focus heavily on revenue deposited from marijuana dispensaries. Financial institutions need to compare revenues deposited from the dispensary with other dispensaries in the area. Specifically, the US Treasury and Justice Department list the following activities that local financial institutions need to check:

- Cash deposits from the dispensaries and ensuring income received from the sale of cannabis products are consistent with the tax figures they are reporting to state and local governments.
- Business revenue to ensure that the dispensary is not receiving unexpected substantial amounts of revenue in contrast to their competitors.
- The revenue is only from the sale of state-legal cannabis products but not any other illegal drugs or activities.

These stringent regulations may create too many challenges for small community banks and make the cost of working with marijuana dispensary clients higher than the benefits banks can receive. These often deter such banks from wanting to work with marijuana dispensaries and ultimately results in them denying them as clients, thereby forcing the dispensaries to operate without a bank and store large amounts of cash in their business which is vulnerable to theft.

A business that operates without a bank tends to be a business without records. A lack of records will make it difficult for state and cities to audit a dispensary. Bank statements provide third party data

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18 California Revenue and Taxation Code – RTC 24343
that help verify gross sales and thus confirming that the dispensary has paid the correct amount of taxes owed. When dispensaries only have records from their point of sale / cash register system, this creates a problem in that POS records generated by the marijuana business can be easily manipulated by the business.

Tax board officials in California floated an idea of forming a state-run bank, but the bank would still need to use Federal wiring services.\(^{21}\) The problem with marijuana industries being a cash only business is that cash is difficult to trace and has restricted state and local governments’ abilities to collect taxes. In the San Francisco Bay Area, it was discovered that about 35% of medical marijuana businesses paid their sales taxes, which was about $27 million.\(^{22}\) Currently, states like California that have legalized the sale of marijuana are unable to find a solution to the banking issues and related tax compliance and audit issues unless the Federal government decides to remove marijuana from its list of dangerous drugs under Schedule I of the Controlled Substances Action (those that are deemed to have no medicinal benefits). If this were to happen, then under current Federal laws it would enable financial institutions to more easily provide full-scale banking services to this industry. Though Prop 64 came with the proposal that the state of California will receive additional tax revenues, the proposition did not provide an overall solution on how the state and cities will collect taxes without a proper audit trail. However, auditing cash-only businesses is not impossible, but audit results may lead to imperfect findings.

**Tax Preparer Concerns**

Most marijuana businesses will need to have an outside tax preparer. Before a tax practitioner accepts a dispensary as a client, an AICPA staff and volunteer generated report (with input from both the Colorado and Washington state CPA societies) recommends that CPAs should first determine how their state board defines and applies “good and moral character.”\(^ {23}\) Though California does not have a clear definition on good and moral character, it is expected that a CPA does have and must maintain this characteristic. With the anticipation of Prop 64 being in full effect in 2018 and the lack of guidance from the California Board of Accountancy, a CPA is placed into an unknown situation. One major concern a CPA may have is that even though on a state level marijuana is legal, it is still illegal under Federal law which could possibly put the CPA's practice and license at risk.

The AICPA staff and volunteer report recommends that CPAs, before accepting a marijuana business as a client, discuss the following questions with their legal counsel:

- What is the position on my state board of accountancy on CPAs providing services to marijuana growers/distributors?
- What is the legal risk of providing services to this industry in this state?
- Will there be a risk of prosecution to a CPA or a CPA firm if they choose to provide services for businesses involved in this industry?
- What are the chances that the Drug Enforcement Administration (DEA) or Department of Justice will prosecute this business?
- How are other CPAs in my state currently offering services to the business?
- Will providing this affect malpractice insurance or personal liability insurance?
- What are the chances that a practitioner will be disciplined, sanction or lose the license by providing services to these businesses?

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\(^ {22}\) Ibid.

\(^ {23}\) See *An Issue Brief on State Marijuana Laws and the CPA Profession* (last updated on 2016 January 8) at: [http://www.aicpa.org/Advocacy/State/DownloadableDocuments/MarijuanaCPAsIssueBrief.pdf](http://www.aicpa.org/Advocacy/State/DownloadableDocuments/MarijuanaCPAsIssueBrief.pdf)
What procedures and policies should be considered to ensure that the potential client understands the state laws concerning marijuana related businesses and if the client is following those rules?

The report also recommended that a CPA should consider conducting background investigations on marijuana clients to ensure that they have been complied with the law. As for any services performed, an engagement letter should specifically state the type of services to be performed as well as the type of services will not be undertaken by the CPA. The practitioner should also require the owners and/or corporate officers of the business to sign a representation letter. This letter should be updated whenever the CPA makes any additions or changes to the firm’s policy. It should also state that the client understands state law requirements and intends to fully comply and will not withhold information from the CPA.

It is also important that practitioners perform proper due diligence under Circular 230. Records from dispensaries are composed by the taxpayers themselves and will not have a bank record to verify the sales earned. However, practitioners may rely on the information in good faith. As long as the practitioner is confident that they have not ignored any information, they can accept the client’s information. As for every client, CPAs should document the work and communication with the client. They should also seek advice from colleagues who work with marijuana businesses. However, if a practitioner or CPA believes that if accepting a marijuana business may create too much risk, they have a right to decline (and should not accept) the business as a client.

Conclusion

The marijuana industry is relatively new in the state of California. Despite the expectation of Prop 64 to raise one billion in tax revenue, there are still unsolved problems on how these potential revenues will be collected or how dispensaries can be compliant with the law. Some of the issues originate from Federal law maintaining its illegal status on marijuana. Other problems result from confusion between Federal, state, and local laws, making practitioners fear violating required codes of conduct. However, laws can change and the industries involved in the sale of cannabis may eventually find a proper place in the tax law.

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24 Ibid.
26 Circular 230 - §10.34(d)
U.S. Tax Forms for American Expatriates
Saqib Amin CPA, MST Student

Americans have another annual ritual besides celebrating the Fourth of July and Thanksgiving: gathering the necessary information to file their U.S. tax returns. Americans living abroad are not exempt from filing U.S. tax returns even if they are working in a space station, deep-water in the North Sea, or have established residency in another country. In fact, the U.S. tax rules for Americans abroad are very complex, with the potential of both significant penalties and an unlimited statute of limitations if they fail to comply with one of the specified foreign information reporting requirements. The good news is that there are some U.S. tax advantages for Americans working abroad. To take benefits of such tax rules, the tax returns must be filed on time. Due to the complexity of the rules, Americans working outside of the United States will likely need assistance from someone who understands these special international tax rules. This article provides an overview of the individual tax return filing requirements of the U.S. expatriates and a list of the most common tax forms for the U.S. expatriate’s income tax return and related financial reporting filings.

For starters, U.S. expatriates must be fully aware of the following:

1. They must file their U.S. (federal) income tax return to report their worldwide income – not just any income earned or effectively connected to the United States.
2. Due to the Foreign Account Tax Compliance Act (FATCA), they may also need to report specified foreign financial assets on Form 8938, along with their U.S. income tax return, if the aggregate value of those assets exceeds certain thresholds. Note that FATCA reporting does not affect the income tax liability on the return.
3. They are required to disclose all non-U.S. financial accounts if the combined total of all accounts is $10,000 or more. This report is commonly referred to as the Report of Foreign Bank and Financial Accounts (FBAR).

(Note: while this article focuses on U.S. citizens and permanent residents living abroad, the rules above, as well as those that follow, also generally apply to those U.S citizens and permanent residents living in the United States.)

Tax Return Filing Requirement

All U.S. citizens and resident aliens are required to file a U.S. income tax return if their gross income meets the minimum filing thresholds. The following table shows the 2016 gross income threshold based on filing status.1

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$10,350</td>
</tr>
<tr>
<td>(65 or older)</td>
<td>$11,900</td>
</tr>
<tr>
<td>Head of household</td>
<td>$13,350</td>
</tr>
<tr>
<td>(65 or older)</td>
<td>$14,900</td>
</tr>
<tr>
<td>Qualifying widow(er)</td>
<td>$16,650</td>
</tr>
<tr>
<td>(65 or older)</td>
<td>$17,900</td>
</tr>
<tr>
<td>Married filing jointly (MFJ)</td>
<td>$20,700</td>
</tr>
<tr>
<td>Not living with spouse at end of year (MFJ)</td>
<td>$4,050</td>
</tr>
</tbody>
</table>

One spouse 65 or older (MFJ) $21,950
Both spouses 65 or older (MFJ) $23,200
Married filing separately $4,050

Note that expatriates with $400 or more of self-employment income are required to file a tax return as well.

When to File

Generally, the deadline for filing Form 1040 individual tax return is April 15. An automatic two-month extension (until June 15) is available for the individuals who are resident abroad. The taxpayer needs to inform the IRS of the extension with a statement attached to the tax return. The U.S. expatriates can file an additional four-month extension (until October 15) if requested by June 15. An additional extension to December 15 is also available to the expatriates abroad. It is important to understand that the tax for the year is due and payable by April 15. Failure to pay all taxes in full by April 15 will result in late payment penalties. Taxpayers can generally avoid late payment penalties by paying their net estimated tax liability (after taking into consideration any taxes withheld or paid-in via estimated tax payments during the year) with Form 4868 by April 15.

Most Common tax forms for U.S. Expatriates

The following lists the most common tax forms for U.S. expatriates and their related requirements:

- **Form 1040, U.S. Individual Income Tax Return.** It is an annual income tax return required for citizens and residents of the United States. Form 1040 is generally the primary U.S. income tax form, and most other forms and schedules are attached to it. American expatriates who are married to citizens of other countries can generally choose to file as “Married Filing Jointly,” “Married Filing Separately,” or “Head of Household” and qualify for a higher standard deduction (for Married Filing Jointly and Head of Household). If the taxpayer is claiming dependency exemptions, a Social Security Number or an Individual Taxpayer Identification Number (ITIN) are required to qualify.²

- **Form W-7, Application for IRS Individual Taxpayer Identification Number.** The Individual Taxpayer Identification Number (ITIN) is a tax processing identification number issued by the IRS, for the purpose of U.S tax return, to individuals who are not eligible for a Social Security Number. ITINs are issued to both resident and nonresident aliens who are required to file Form W-7, regardless of their immigration status. The following are examples of individuals who may need ITINs:
  - A nonresident alien required to file a U.S. tax return
  - A U.S. resident alien (based on days present in the United States) filing a U.S. tax return
  - A dependent or spouse of a U.S. citizen/resident alien
  - A dependent or spouse of a nonresident alien visa holder

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• **Form 2555, Foreign Earned Income.** U.S. citizens and U.S. resident aliens living in a foreign country who meet the tax home test,\(^3\) bona fide residence test,\(^4\) or the physical presence test\(^5\) can elect to exclude foreign earned income up to the IRC Section 911 limitation, and certain foreign housing costs. The exclusions are adjusted annually for inflation.\(^6\) Exclusion for foreign housing is based on actual expenses and the table is provided by IRS in its instructions to Form 2555. Taxpayers may not claim certain tax credits (e.g. child tax credits) and deductions (e.g. IRA and Roth IRA) if they claimed the foreign earned income exclusion. In some situations, it might be beneficial not to take foreign earned income exclusion and claim other tax credits instead.

• **Schedule SE, Self-Employment Tax.** U.S. expatriates and resident aliens are subject to the same self-employment tax rules as those who are living in the United States. These taxpayers must pay tax on self-employment income of $400 or more. The IRC Section 911 exclusion does not apply to self-employment tax. The United States has bilateral Social Security agreements with certain countries, commonly known as Totalization Agreements. These agreements exempt citizens of one country from similar social security-type taxes in a foreign country, as long as they are contributing to their home country’s social security system.

• **Form 1116, Foreign Tax Credit.** This form is used to claim foreign tax credits on a U.S. tax return for the income taxes paid in foreign jurisdictions on foreign-sourced income. Note that a U.S. expatriate cannot claim foreign tax credits or deduction on the income that is part of the foreign earned income exclusion and the foreign housing exclusion. The foreign tax credit has a current year limitation that is calculated as the following:

Maximum foreign tax credit allowed in the current year = (Foreign source taxable income/Total worldwide taxable income) multiplied by the taxpayer’s U.S. tax liability (before any reduction based on a foreign tax credit).

This means that if the foreign tax paid is greater than what the U.S. tax liability would have been on the foreign source income, the foreign tax credit is limited to only the U.S. tax liability on the foreign income.

The excess amount of foreign taxes that are not creditable due the limitation can be carried back one year and carried forward ten years. These foreign tax credits can be used to offset U.S. tax on foreign source income of these carryback or carryforward years.

• **Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or Section 7701(b).** If a U.S expatriate or U.S. resident alien is living in a country that has an income tax treaty with the United States, he or she may be entitled to certain benefits under the treaty. For example, income tax treaties provide benefits for individuals engaged in dependent personal services (i.e., employment) and independent personal services (i.e., self-employment). Generally, if certain

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\(^3\) According to Treas. Reg. §1.911-2(b) the term “tax home” has the same meaning which it has for purposes of section 162(a)(2) (relating to travel expenses away from home). Thus, under section 911, an individual’s tax home is considered to be located at his regular or principal (if more than one regular) place of business or, if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in a real and substantial sense. An individual shall not, however, be considered to have a tax home in a foreign country for any period for which the individual’s abode is in the United States. Temporary presence of the individual in the United States does not necessarily mean that the individual’s abode is in the United States during that time. Maintenance of a dwelling in the United States by an individual, whether or not that dwelling is used by the individual’s spouse and dependents, does not necessarily mean that the individual’s abode is in the United States.

\(^4\) A person is considered a “bona fide resident” of the foreign country if that person resides in that country for an uninterrupted period that includes an entire tax year.

\(^5\) Under *Physical Presence Test*, a person is considered physically present in a foreign country if the person resides in that country for at least 330 full days in any consecutive 12-month period.

\(^6\) The maximum foreign earned income exclusion is $102,100 for 2017 and $101,300 for 2016.
conditions are met, such treaties provide an exemption for tax withholding requirement on payments to non-residents. If a treaty-based position in taken in a return, it should be disclosed on Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or Section 7701(b). The benefit may include credits, deductions, exemptions, and reductions in the rate of taxes.

- **Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company (PFIC) or Qualified Electing Fund.** If a U.S. citizen or U.S. resident alien invests savings through a non-U.S. financial institution, it may be considered a PFIC that requires significant costs and efforts in tax reporting. PFICs are “pooled investments” registered outside the U.S. that include mutual funds, money-market account, hedge funds, certain insurance products and foreign retirement plans. Foreign pension plans could be exempt if recognized as “qualified” under tax treaty. PFICs are any corporation organized under the laws of a non-U.S. jurisdiction, which satisfies either an income test (75% or more of foreign entity’s income is passive) or an asset test (at least 50% of assets of foreign entity produce or held to produce passive income). The tax treatment of PFICs is more punitive related to similar investment held thorough a U.S. institution. For example, capital gain classified as PFICs could be subject to the highest individual tax rate of 39.6% instead of the long-term capital gain rate of 15%. Additionally, the disclosure requirement on Form 8621 is complex. Under the rules, there are three alternative methods to determine the taxable income of the investment in each fund. Each method is designed to eliminate the benefit of deferral that is one of the main benefits of a foreign mutual fund. The specifics depend on whether the taxpayer made any PFIC election such as an election to treat the PFIC as a qualified electing fund (QEF), or an "election to mark-to-market PFIC stock". If no election is made, the "default" PFIC tax regime of IRC Section 1291 applies. Due to the complexity of these rules, the IRS estimates that for the year 2016, individual taxpayers would require 47 hours for recordkeeping, learning about the rules of the form and preparing the form.7

- **FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).** A U.S. citizen or U.S. resident alien is required to file this form if he or she had a financial interest, signature or other authority over a bank, securities, or other financial account in a foreign country if the combined balance in all such accounts exceeds $10,000. Form 114 is not filed with IRS. It is filed electronically with the Financial Crimes Enforcement Network (Fin-CEN), an agency within the U.S. Department of Treasury.8 Failure to file or maintain the required records carries severe penalties, especially if the government determines that the violation was willful. The due date for FBAR filing was recently changed from June 15 to April 15 for tax years beginning after December 31, 2015. In addition, the law provides an automatic six-month extension (without the need to file for an extension) until October 15.9

- **Form 8938, Statement of Specified Foreign Financial Assets**. Also known as the FATCA form, is used to report a U.S. person’s specified foreign financial assets if the total value of all the specified foreign financial assets, in which he or she has an interest, is more than the appropriate reporting threshold. Specified foreign financial assets include any financial account in a foreign financial institution and any investment in securities, interest, or instrument in a foreign entity where

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9 See the December 16, 2016 FinCEN Release at: https://www.fincen.gov/news/news-releases/new-due-date-fbars-0
counterparty that is not a U.S. person. This form has some overlap with the FinCEN 114 Form, but
the filing thresholds are higher and depends on the taxpayer’s residency and marital status. These
thresholds range from a low of $50,000 to a high of $600,000 for the highest value during the year
and on the last day of the year. Please note that Form 8938 is not a replacement of FinCEN 114
Form. There could be a $10,000 civil penalty for failure to file Form 8938, with additional $10,000
penalties up to a maximum of $50,000 after a notice from the IRS. The statute of limitations for the
entire 1040 return is also extended if Form 8938 is not filed when required.

- **Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of
  Certain Foreign Gifts**\(^\text{11}\). U.S. citizens or U.S. resident aliens (and executors of estates of U.S.
decedents) are required to file this form to report certain transactions with foreign trusts,
ownership of foreign trusts, and receipt of certain large gifts or bequests from certain foreign
persons. A separate Form 3520 must be filed for transactions with each foreign trust. Reportable
event for filing Form 3520 include the following:
  - Formation of a foreign trust
  - Conversion of domestic trust to foreign trust
  - Transfer of assets to foreign trust
  - Sale of a foreign trust if it is not at “arms-length” transaction
  - Death of a US grantor of a foreign trust

Generally, a penalty is imposed if Form 3520 is not timely filed, or if the information is incomplete
or incorrect.

- **Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner (Under Section
  6048(b))**. The trustee of a foreign grantor trust is required to file Form 3520-A annually. If a
foreign trustee does not file the form with IRS, then in addition to Form 3520, a grantor in a foreign
trust is also required to file Form 3520-A to provide information about the trust, its U.S.
beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust.
This form is similar to Form 1041, U.S. Income Tax Return for Estates and Trusts.

- **Form 8832, Entity Classification Election**. The entity classification regulations under IRC section
7701, known as check-the-box regulations, allows certain business entities to choose their
classification for the U.S. federal tax purpose. The classification of a foreign entity as a corporation,
a partnership, or a disregarded entity, affects many aspects of the U.S. taxation. If a U.S. expatriate
owns his or her own business and sets up a legal entity in the country of residence, the entity is
classified as either a partnership, corporation or a disregarded entity based on the following
criteria:

1) A partnership if it has two or more members and at least one member does not have limited
liability.

2) An association taxable as a corporation if all members have limited liability.

3) A disregarded as an entity separate from its owner if it has a single owner that does not have
limited liability.\(^\text{12}\)

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\(^{11}\) See IRS “Instructions for Form 3520” at https://www.irs.gov/uac/about-form-3520

\(^{12}\) See the foreign default rule in the Form 8832 instructions.
However, Form 8832 can be used to change the classification of the foreign entity as a disregarded entity (with a single member) or a partnership (at least two members) if certain requirements are met. For example, a single member limited liability company that is owned by an individual can be elected to be treated as a corporation.

- **Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities.** A U.S. person is required to file this form if he or she owns, directly, indirectly, or constructively, a foreign business entity that is classified as a disregarded entity.

- **Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations.** This form is “used by certain U.S. persons who are officers, directors, or shareholders in certain foreign corporations. The form and schedules are used to satisfy the reporting requirements” of transactions between foreign corporations and U.S. persons\(^\text{13}\). A separate Form 5471 and all applicable schedules is required for each foreign entity that is classified as a corporation for U.S. federal tax purposes. IRC Section 6038(b)(1) imposed $10,000 disclosure penalty for each Form 5471 that is not filed or incomplete. There is additional $10,000 penalty “if the failure continues for more than 90 days after the IRS mails notice of failure.”\(^\text{14}\)

- **Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships.** This form is required to be filed if a U.S. person owns an interest in a foreign eligible entity that elects to be classified as a foreign partnership for the U.S. federal tax purposes. This form is used to report “transfers, acquisitions, dispositions, and changes in foreign partnership interests” along with other financial information. This form is required to be filed with the partner’s tax return. There is a penalty of $10,000 per year for each partnership return that is not filed when required. A 10% partner, who makes a contribution of property to a foreign partnership and does not disclose the transfer, is subject to a penalty of 10% of the amount transferred up to $100,000.

- **Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation.** This form is required to be filed by a U.S. person upon certain transfers or deemed transfers of tangible or intangible property to a foreign corporation. If a taxpayer fails to file the form, there would be penalty equals 10% of the fair market value of the property at the time of the transfer. The penalty will not apply if the failure to comply is due to reasonable cause and not to willful neglect. The penalty is limited to $100,000 unless the failure to comply was due to intentional disregard\(^\text{15}\). This form is filed with the tax return of transferor for the year the transfer is made.

- **Form 8275 Disclosure Statement and Form 8275-R Regulation Disclosure Statement.** According to IRS instructions, “Form 8275 is used by taxpayers and tax return preparers to disclose items or positions, except those taken contrary to a regulation, that are not otherwise adequately disclosed on a tax return to avoid certain penalties. The form is filed to avoid the portions of the accuracy-related penalty due to disregard of rules or to a substantial understatement of income tax for non-tax shelter items if the return position has a reasonable basis. It can also be used for disclosures relating to the economic substance penalty and the preparer penalties for tax

\(^{13}\) The form and schedules are used to satisfy the reporting requirements of sections 6038 and 6046, and the related regulations

\(^{14}\) See IRS “Instructions to form 5471” at [https://www.irs.gov/instructions/i5471/ch01.html#d0e22](https://www.irs.gov/instructions/i5471/ch01.html#d0e22)

understatements due to unreasonable positions or disregard of rules.”

This form is filed by “individuals, corporations, pass-through entities, and tax return preparers.” When “disclosing a position taken contrary to a regulation, use Form 8275-R, Regulation Disclosure Statement, instead of Form 8275.”

Disclosures are necessary when dealing with certain expatriate tax issues, for example the timing or sourcing of foreign income and taxes, sometimes it is not possible to get a 100 percent assurance that the position taken on the expatriate tax return is the correct. Another example could be the valuation method used to quantify foreign assets when calculating gain or loss. The rules are complex, and the application is not very clear. In these situations, Form 8275 or Form 8275-R should be used to disclose the position. It will provide a valuable protection for both the tax preparer and the taxpayer as long as the position is not frivolous, made in good faith, substantiated. If the tax preparer feels that this form is necessary, it should be discussed with the taxpayer.

This is not a comprehensive list of all the forms U.S. expatriates may need to file. The list does not include tax forms that are generally filed with domestic taxpayers without foreign activities or assets.

**Statute of limitations rules for non-compliance with certain foreign information reporting requirement**

Generally, there is three years of statute of limitation after tax return is filed. The statute is extended to six years if 25% of income is omitted from the tax return. In the case of foreign information reporting, we need to pay special attention to IRC section 6501(c)(8). It states, “in the case of any information which is required to be reported to the Secretary pursuant to an election under section 1295(b) or under section 1298(f), 6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048, the time for assessment of any tax imposed by this title with respect to any tax return, event, or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section...If the failure to furnish the information ... is due to reasonable cause and not willful neglect, (this) apply only to the item or items related to such failure.”

The IRC sections listed in section 6501(c)(8) related to foreign information reporting on forms 5471, 8865, 8858, 5472, 926, 8865, 8621 and 8938.

It means that the taxpayers and their tax accountants need to fully understand which foreign informational forms they are required to file and make sure that the forms are complete, accurate and filed on time. If any of these required forms is missing or containing errors, it should be amended so that the statute of limitation does not stay open forever.

**Take-away**

If a U.S. person is on a short-term assignment to a foreign country or a commuter assignment, generally he will not be eligible for foreign earned income exclusion under IRC section 911. The U.S. person must reside outside the United States and must meet either the Bona Fide Resident or the Physical Presence test to qualify for the exclusion. If the U.S. person had paid or accrued income taxes in the country of assignment, he can claim foreign tax credits in the U.S. with certain limitations via Form 1116. He does not have to file

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16 See IRS “Instructions to form 8275” at https://www.irs.gov/instructions/i8275/ch01.html
17 See IRS “Instructions to form 8275” at https://www.irs.gov/instructions/i8275/ch01.html
18 See IRC Section 6501
FinCen Form 114 or Form 8938 if he does have any beneficial interest or signature authority in a non-U.S. account at a foreign financial institution.

On the other hand, the situation would be different if a U.S. person is residing in a foreign country on long-term basis. Let’s say that a U.S. person moved to France and started his own business as a sole proprietorship. In this case, once he meets either the Bona Fide Resident or Physical Presence tests, he will qualify for the IRC section 911 exclusion (Form 2555). Even if he can exclude all of his foreign earned income from his business for income tax purposes, he will still be subject to the self-employment tax (Schedule SE). If all the foreign earned income is excluded, he will not be able to use foreign tax credits for French taxes paid. He will be subject to FBAR (FinCen Form 114) and FATCA reporting (Form 8938) requirements if he has foreign financial assets above the threshold amount. If he has an ownership interest in a passive foreign investment company (PFIC) – typically foreign-based companies that either have 75% or more of their income is the form of passive income or 50% or more of their assets as passive assets), he will be subject to potential PFIC reporting and subject to the U.S. tax on that income (Form 8621). If he is benefiting from US-France income tax treaty, he will have to disclose the treaty-based return position on Form 8833.

You can see that even if a U.S. expatriate does not have any activities with a foreign trust or ownership in a controlled foreign corporation or foreign partnership, his tax return could still be complex. The risk may not just be the miscalculation of the U.S. tax liability. The real risk is associated with the misreporting that carries severe penalties even if there is no tax liability is due.

Tax accountants who provide services to U.S. citizens or U.S. resident aliens abroad should understand the extensive and complex filing requirements related to U.S. persons abroad and their foreign assets. They have to make sure that the clients understand these requirements and the risk associated with noncompliance. To reduce the chance of miscommunication, they need to ask appropriate questions to understand the expatriates’ situation. For example, a U.S. expatriate is likely to answer “no” when asked if they have any Passive Foreign Investment Company (PFIC) account. It is because they probably do not understand what a PFIC means. The tax penalties for failure to file these forms are severe. As a result of the FATCA initiative, the IRS is receiving more information about U.S. persons’ foreign financial assets from the foreign financial institutions. It is just matter of time for the IRS to go through all the FATCA data and initiate audits for the unreported foreign assets of the U.S. persons.
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

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 factors. 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:

- 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.

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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. 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. 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:

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.

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.

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. 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

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3 Reg. §1.385-2
4 Reg. §1.385-2(b)(2)
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

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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)
16 Reg. §1.385-3(c)(2)
17 Reg. §1.385-3(c)(2)
18 Reg. §1.385-3(c)(4)
19 Reg. §1.385-2
20 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 restructurings 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

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.

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²IRM 4.45.4.4.
³The 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. The controlled taxpayer must use the arm’s length standard to determine the true taxable income from the related party transactions. 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. 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."

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. 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.

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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. The controlled transactions in these two cases involved related products or services. Since the transactions were so interrelated, the IRS decided to consider the combined effect by aggregating the transactions. 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. The taxpayers disagreed with the IRS and argued that the adjustments should be made to separate transactions instead.

1. Guidant
   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.

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)" and the essence of the consolidated returns principle is to “levy tax according to the true net income.” 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
   Similar to Guidant, in Metronic 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

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<td>7 Reg. Section 1.482-1[b][2][ii]</td>
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<td>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.</td>
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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 Nath\(^{18}\) 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.

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\(^{16}\) *Control* in the context of control premium does not refer to the "control" within the meaning of IRC Section 482.


\(^{18}\) Eric Nath, ASA, is the principal owner of Eric Nath & Associates, LLC in San Francisco, CA.

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.”

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. 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. 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. 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.

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. 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.

22 3M Co. v. Comm’n, Tax Court Docket No. 005816-13
23 Reg. Section 1.482-1(h)(2)
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

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

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1 IRB 2016-42 (442)
2 Treas. Reg. § 1.41-4(e)

https://scholarworks.sjsu.edu/sjsumstjournal/vol6/iss2/1
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.

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3IRB 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 5. 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.

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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. 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).

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.

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

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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 an 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:

<table>
<thead>
<tr>
<th>Acquisition Period</th>
<th>Exclusion Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>8/11/1993 - 2/17/2009</td>
<td>50%</td>
</tr>
<tr>
<td>2/18/2009 – 9/27/2010</td>
<td>75%</td>
</tr>
<tr>
<td>9/28/2010 and later</td>
<td>100%</td>
</tr>
</tbody>
</table>

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

- 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.

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\(^3\) IRC Section 1202(d)
\(^4\) IRC Section 1202(b)(1)
\(^6\) 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 Updates 11

**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

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8 California Code of Regulations, Title 18, Section 25136-2(d)(1)(A)
9 California Code of Regulations, Title 18, Section 25136-2(d)(1)(A).
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](http://www.rev.state.la.us/CorporationIncomeAndFranchiseTaxes)
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).
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- International High Technology U.S. Tax Current Developments
- Supply Chain Planning
- Indirect Taxes in the Digital Economy
- Protecting Your Exit Strategies
- Federal Tax Controversies – Technical Issues and Strategies
- Accounting for Income Taxes
- IP Location Planning
- Brexit Tax Implications
- Tax Automation: AI, Robots, Blockchain and More
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1. In Year 1, Gardner used funds earmarked for use in Gardner’s business to make a personal loan to Carson. In Year 3, Carson declared bankruptcy, having paid off only $500 of the loan at that time. In Year 1, Gardner purchased equipment for use in Gardner’s business. In Year 3, Gardner sold the equipment at a $5,000 loss. In January of Year 3, Gardner received shares of stock as a gift from Smith; the shares had been purchased by Smith in Year 1. In November of Year 3, Gardner sold the property for a $5,000 gain.

Which of the above transactions will Gardner report as a long-term capital gain or loss for Year 3?

I. The bad debt write-off
II. The sale of equipment
III. The sale of shares

a) II and III only.
b) None of the above.
c) I only.
d) III only.

d) Correct! The uncollectibility of a personal loan represents a nonbusiness bad debt, which is treated as a short-term capital loss, regardless of the holding period. Depreciable business property held longer than one year is Section 1231 property and losses on sale are treated as ordinary, not capital losses. Shares received by gift will retain donor’s holding period and basis. Since the shares had been purchased by the donor more than 1 year before their sale, the result would be a long-term capital loss.

2. Betty, a salesperson, is an employee with $52,000 AGI who maintains a home office for the convenience of her employer, Smart Systems. The office takes up 5% of Betty’s home and is used exclusively for her job. Smart Systems reimburses all of Betty’s direct costs of maintaining the home office. Betty also has the following expenses associated with her home:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real property taxes on residence</td>
<td>$3,500</td>
</tr>
<tr>
<td>Interest expense on residence</td>
<td>$5,000</td>
</tr>
<tr>
<td>Operating expenses on residence</td>
<td>$1,800</td>
</tr>
<tr>
<td>Depreciation on residence (based on 5% home office use)</td>
<td>$150</td>
</tr>
</tbody>
</table>

Considering these facts, how much may Betty deduct from AGI on her tax return, assuming she elects to itemize deductions?

a) $0
b) $665
c) $9,410
d) $10,450

a) Correct! When a home office is maintained for the convenience of the employer, the expenses related to that portion of the home are deductible as miscellaneous expenses. This would include 5% of the real property taxes, interest expense, and operating expenses and all of the depreciation on the 5% used as a home office. As a result, total expenses will be 5% x ($3,500 + $5,000 + $1,800) +
$150 or $665. A deduction is allowed to the extent that the amount exceeds 2% of AGI. Since the total of $665 does not exceed 2% of $52,000 or $1,040, there is no deduction.

3. In Year 7 Standard Corp., a C corporation, sold Section 1250 property for $600,000 that had an adjusted basis of $550,000, resulting in a $50,000 gain. The property had cost Standard $720,000 when purchased in Year 1, and $170,000 of accelerated depreciation had been taken. Had straight-line depreciation been used, depreciation would have been $100,000. How should Standard report the gain on its Year 7 tax return?

a) $20,588 ordinary gain and $29,417 long-term capital gain  
b) $28,824 ordinary gain and $41,176 long-term capital gain  
c) $70,000 ordinary gain  
d) $50,000 ordinary gain  

d) Correct! When section 1250 property that has been held for more than 1 year is sold at a gain, excess depreciation is recaptured, resulting in an ordinary gain with the remainder, if any, recognized as long-term capital gain. Excess depreciation for a C corporation consists of the difference between the amount taken using an accelerated method and the amount that would have been allowed under straight-line, $170,000 - $100,000 or $70,000, plus 20% of the amount allowed under straight-line, $100,000 x 20% or $20,000 for a total of $90,000. Since this exceeds the amount of the gain, the entire $50,000 gain would be ordinary.

4. Preakness Partnership makes a current distribution to Prasad consisting of $30,000 in cash, land with a fair market value of $50,000 (partnership basis $55,000), and inventory with a fair market value of $8,000 ($3,000 partnership basis). Immediately prior to the distribution Prasad’s outside basis in the partnership was $35,000. What amount of gain will Prasad recognize on the distribution, and what is Prasad’s resulting basis in the land?

<table>
<thead>
<tr>
<th>Recognized Gain</th>
<th>Basis in Land</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) $3,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>b) $0</td>
<td>$0</td>
</tr>
<tr>
<td>c) $0</td>
<td>$2,000</td>
</tr>
<tr>
<td>d) $3,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

c) Correct! In accounting for the distribution, Prasad will account for the cash of $30,000, reducing Prasad’s basis from $35,000 to $5,000. The inventory will be recognized at the partnership’s basis of $3,000, leaving Prasad a basis of 2,000, which will be the basis in the land. Gain would only be recognized if the amount of cash distributed exceeded Prasad’s basis in the partnership.
The Contemporary Tax Journal's Interview of Mr. Gary Sprague
By: Xuan Hong, MST Student

Mr. Gary Sprague, a tax partner based in international law firm Baker & McKenzie's Palo Alto office, is a recognized leader in the international law and e-commerce law field. With decades of international taxation experience, Mr. Sprague was appointed by the OECD to serve as the business co-chair of the OECD Technical Advisory Groups ("TAG") on business profits and treaty characterization issues. Mr. Sprague also serves on the International Fiscal Association's Executive Leadership Committee, as well as Tax Management's U.S. International Advisory Board. As a top U.S. West Coast Tax Advisor, Mr. Sprague devotes time to the development of U.S. and international tax policy matters on behalf of clients. Mr. Sprague shares his research and perspectives via numerous publications and conferences. He regularly contributes to Tax Management International Journal's Leading Practitioner Commentary, as well as to the annual TEI-SJSU High Tech Tax Institute conference in Silicon Valley.

Despite such amazing achievements in the tax field, Mr. Sprague, however, said taxation was not his first choice of law fields at the beginning of his career. What led Mr. Sprague to step into the tax law area and take on significant roles in serving clients on complex tax matters and help many countries shape international tax policies? In this interview with Mr. Sprague, he shared his career path in the tax field and his views of taxation as a profession.

Following are questions asked by CTJ and a summary of Mr. Sprague's answers.

1. [CTJ] How did you get involved in the tax field and with a focus on international taxation?

[Sprague] In part, it was by design. In other parts, it was by luck - both good and bad, or at least it seemed bad at the time. By the time I entered law school, I knew that I was aiming for a career dealing with international matters. I had taken the first set of tests leading to a possible position in the U.S. Foreign Service, but withdrew from the process in order to focus on law school. There, I took several courses that addressed legal issues arising from cross-border transactions. International tax was one of the more interesting classes I took. Apparently, I wasn’t very good at it; it was one of my lowest grades in law school.

By graduation, I had decided that I wanted a career in international banking. So, I joined a firm in San Francisco that boasted a large practice advising mostly non-US banks. The firm also was well known for its admiralty work. Pictures of the subjects of its most famous admiralty cases lined the walls. That created something of an ominous sense in the halls, as the most famous cases for an admiralty firm are generally ships running into things like bridges or islands, or sinking in heavy seas. The firm also had a very small tax practice that supported its international shipping clientele.

The bad luck (at the time) partly arose because among the four entering first year associates, I took the longest break between the bar exam and beginning work. When I finally showed up for the first day of work, to my dismay I learned that the firm allocated department assignments for the four first years on a first come, first served basis. The position in the high profile banking group was long gone, snagged by a much more punctual candidate. All that was left was the one position that none of the others wanted - tax.

Not having any better options, I agreed. At least the firm promised that after a year, they would reconsider whether I could transfer to a more interesting department. Just before my first-year anniversary, the sole tax partner disappeared. It was never clear to me whether he was fired or resigned. A lateral partner recruit showed up to take his place. Firm management implored me...
to reenlist in tax for another year, to help with the transition. I was the only associate in the corporate tax area. The flattery worked, so I signed up for a second year in the tax department.

As it turned out, the international tax treatment of shipping enterprises was unexpectedly interesting. Tax treaties normally contained an article dealing with international transportation income, U.S. domestic law had special sourcing rules for shipping, and subpart F had its own shipping income category. I began to think that perhaps tax wasn’t so dull after all. But it was clear that the opportunities to develop skills in the broader international tax area were always going to be limited at this firm. So, when Baker & McKenzie announced that it had an opening for an associate in the tax group in San Francisco, I jumped at the chance.

2. [CTJ] What led you to become actively involved in tax work of the OECD?

[Sprague] In the late 1990s, the OECD undertook a series of projects to explore the tax policy aspects of e-commerce. The OECD took the admirable step of organizing this work through a series of Technical Advisory Groups (TAGs), which were comprised of representatives of OECD Member countries, non-Member countries, and business. The business representatives were nominated through the Business and Industry Advisory Committee (BIAC) of the OECD. I had begun to be involved in some BIAC work on international tax matters, and by then Baker & McKenzie was starting to be known as leading advisors to the high-tech community in Silicon Valley. BIAC offered to put my name forward as a member of the TAG on treaty characterization issues, and the OECD agreed.

Our work was to examine several common e-commerce transactions and advise whether they should be characterized as royalties, business profits, or payments for the use of industrial, commercial or scientific equipment for tax treaty purposes. Our work eventually was adopted and published by the OECD, and some of our text made it into the OECD Model Tax Convention Commentary. The business representatives on the TAG chose me as the business co-chair, which turned out to be a very fortuitous decision, as the co-chairs were able to exercise direct influence of the technical drafting of the report. Based on my work on the treaty characterization TAG, the OECD then invited me to participate on the Business Profits TAG, which principally was focused on whether the Permanent Establishment (PE) standards of Article 5 should change in response to e-commerce business models.

3. [CTJ] What stands out as one or two of your most significant accomplishments regarding your work with the OECD?

[Sprague] I think it is not one item, as much as the nearly 20 years of engagement since the original e-commerce TAGs. The OECD has continued to invite business input on its proposals, and I have been fortunate to be asked by our clients to continue to advocate for sound tax policy at the OECD on their behalf. Some issues are never resolved completely. My two TAGs addressed characterization and PE, and those issues are right back on the table now except in the context of the "digital economy" instead of "e-commerce."

4. [CTJ] How do you keep up to date with the tax law as well as technology so you understand how tax rules apply to it?

[Sprague] That is pretty much an impossible task. The best strategy is to practice with a lot of really smart colleagues. From the perspective of providing a full range of tax advice to our clients, I rely on my colleagues to make sure that we as a firm have deep technical expertise in all relevant areas.

5. [CTJ] What do you think is one key area of our federal tax system that could/should be improved and why?
[Sprague] We need international tax reform immediately. Our current rules are not competitive with those of our major trading partners. This disadvantages U.S. multinationals.

6. **[CT] What advice do you have for someone starting their tax career today?**

[Sprague] Ask yourself whether you really enjoy working with the tax law, or whether it is just a job. If it's just a job, tax may not be for you. If you are really engaged with the intellectual rigor of the work, then you will have a long and satisfying career.

**Fun questions:**

7. **[CT] If you could have dinner with anyone, who would it be?**

[Sprague] Mozart. It is hard to comprehend how a single person could envision and then create such a radical advance in his chosen art form over what had preceded him. I'd like to ask him whether he thought of his work in terms of making incremental steps over the prior art, or whether the new music just emerged wholly formed in his mind.

8. **[CT] What is the most unusual item in your office or something in it that has special meaning?**

[Sprague] On weekends, I am a youth soccer referee. The way one works one's way up through the ranks is to start with younger matches in less competitive leagues, then graduate to older matches in more competitive leagues. Fairly early on in my referee career, I was given an end-of-season award: Under 12 girls "most improved referee." They gave me a nice plaque. I was quite proud of the recognition, and determined to hang the plaque on my office wall. While admiring it, it suddenly occurred to me that there was an unstated fact implicit in the award - that in order to be "most improved" this fellow must have had lots of room to improve. So, the plaque is still on my wall, as a reminder of humility and that there is always room to improve.

[CT] **editor observation**] For newcomers considering taxation as their professional direction, Mr. Sprague uses his own experiences to show that if you are willing to put your heart and action on the field, you would make a difference in your career life.
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