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The Contemporary Tax Journal Summer 2018

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Letter from the Editor

We are honored to present you the Summer 2018 edition of The Contemporary Tax Journal, a publication of the San Jose State University MST program.

This issue begins with a *Tax Enlightenment* article. **Chau Le** examines the Head of Household filing status and a dispute involving its application in the recent court case *Tommy J. Walker, Jr. v. Commissioner*. In the article, Chau analyzes the reasoning underlying the court's decision and addresses his concern over the judge's omission of reading the law in full context.

Next, the *Tax Feature* section presents summaries of selected sessions of the 33rd Annual TEI-SJSU High Tech Tax Institute in November 2017. The topics covered in this section include accounting for income tax, recent developments in tax automation, IP location planning, supply chain planning in response to the pending tax reform, and recent domestic and multistate updates. These contributions are from the fellow students of the MST program.

The *CPA Exam Review* section includes the latest multiple choices questions from Becker CPA Review – Regulation section. We would like to thank Becker CPA Review's generous support and hope you will find this section helpful in preparing for your next CPA exam.

Our *Tax Maven* section of this issue is **Mr. Eric Ryan**, a leading icon in the Silicon Valley, who concentrates in international tax, transfer pricing, and mergers and acquisitions. Mr. Ryan is a partner at DLA Piper, former Tax Director at Apple Computer, Inc., and now teaches two courses in the MST program at San Jose State University. I am honored to have interviewed him and learned about his over 25 years of experience in the tax field. I hope his advice will inspire you as much as you enjoy reading his interesting answers.

Something special about this issue is that all content is generated during a transition of the U.S. tax system from 2017 to 2018. As the Tax Reform was moving forward, the professionals at the High-Tech Tax Institute addressed the potential impact of the tax reform and recommend changes in practice and operations to tax practitioners in order to better adapt to the new laws. As such, our journal's editorial team also wants to recognize this historical time that shakes out and changes a significant amount in our tax system, focuses on the new tax developments going forward and makes a continuous commitment to produce quality deliverables to our readers.

Finally, I want to express my sincere gratitude to **Professor Annette Nellen and Professor Joel Busch** for their guidance, support and tireless efforts throughout the editing process. I also greatly appreciate all the contributions made by the fellow students, as well as Catherine Dougherty, our MST coordinator, and Rani Vaishnavi and Rachana Khandelwal, assistant student editors for their insights and hard work to shape and polish the journal, and finally made this issue possible.

Please enjoy the Summer 2018 issue of *The Contemporary Tax Journal*.

Sara (Yaqin) Sun
Student Editor

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Analysis of the Head of Household Filing Status

By: Chau Le, *MST Student*

Tax Filing Status

When it comes to filing individual tax returns, one of the most important tasks for taxpayers is to figure out their filing status. Current tax law allows the following status: Single, Married Filing Jointly, Married Filing Separately, Qualifying Widow(er) with Dependent Child, and Head of Household.[1] As their names refer, only married taxpayers can elect to file as Married Filing Jointly or Married Filing Separately. A taxpayer is deemed married if his or her spouse dies during the taxable year.[2] Likewise, only unmarried taxpayers can elect to file as Single or Head of Household. Tax law defines a taxpayer as unmarried if the taxpayer is legally separated from his spouse under a decree of divorce or of separate maintenance, or if any time during the taxable year his spouse is not a non-resident alien.[3] Besides, a married taxpayer who is not living with the spouse will be considered unmarried for the taxable year if he files a separate return and during the taxable year he maintains his house as a household of a child for more than one half of the year. The taxpayer must also provide more than one half of the cost of maintaining the house and does not live with his spouse during the last 6 months of the taxable year.[4] For those that can file their tax returns as Head of Household, it allows them to claim a higher standard deduction putting them in lower tax brackets, as compared to the Single filing status, which eventually results in a favorable tax treatment for them. Specifically, for the tax year 2017, taxpayers filing as Head of Household can deduct $9,350 from their taxable income as the basic standard deduction while those filing as Single can only deduct $6,350 from their taxable income.[5] Higher standard deductions normally result in lower taxable income, reducing the final amount of tax owed by taxpayers.

[1] IRC §1
[2] IRC §2(b)(2)(A), (B)
[3] IRC §2(b)(2)(C)
[4] IRC §7703
[5] IRC §63

For the tax year 2017, federal tax rates for those filing as Head of Household and Single are shown in the following table:[6]

Heads of Household		**Single**	
If taxable income is	**The tax is**	**If taxable income is**	**The tax is**
Not over $29,600	15% of taxable income	Not over $22,100	15% of taxable income
Over $29,600 but not over $76,400	$4,440 plus 28% of the excess over $29,600	Over $22,100 but not over $53,500	$3,315 plus 28% of the excess over $22,100
Over $76,400 but not over $127,500	$17,544 plus 31% of the excess over $76,400	Over $53,500 but not over $115,000	$12,107 plus 31% of the excess over $53,500
Over $127,500 but not over $250,000	$33,385 plus 36% of the excess over $127,500	Over $115,000 but not over $250,000	$31,172 plus 26% of the excess over $115,000
Over $250,000	$77,485 plus 39.6% of the excess over $250,000	Over $250,000	$79,772 plus 36% of the excess over $250,000

According to the table, for the same amount of taxable income, Head of Household taxpayers will pay less tax than Single taxpayers do. For example, if taxable income is $60,000, a Head of Household taxpayer will owe $9,252.50 in tax while a Single taxpayer will owe $10,738.75 in tax.

For tax saving purposes, more and more unmarried taxpayers prefer Head of Household status to Single status. However, among these taxpayers, many do not fully understand the requirements for electing the Head of Household status. The tax law imposes strict guidelines and taxpayers must satisfy certain requirements in order to file as a Head of Household.

[6] IRC §1(b),1(c)

This article looks into the case of *Tommy J. Walker, Jr.*,[7] where a taxpayer failed to satisfy the requirements for the Head of Household filing status, explores requirements for Head of Household status, and other items such as the dependency exemption, Child Tax Credits, the Additional Child Tax Credit, and the Earned Income Tax Credit. Additionally, we will also discuss the ruling of the judge in the case and provide an overview of the court proceedings.

Tommy J. Walker, Jr. v. Commissioner[8]

In this case, the taxpayer, Tommy J. Walker, Jr., lived with his girlfriend and her son during two full taxable years in an apartment. He paid a portion of the rent while the other portion was subsidized by the government. He also provided more than one half of financial support to his girlfriend's son.

During the taxable year, a daughter of the taxpayer's cousin moved into his apartment. However, the taxpayer could not provide sufficient evidence showing the amount of time she had lived with him.

For the two taxable years in dispute, Walker elected Head of Household status in his tax returns and claimed dependency exemption deductions for his girlfriend's son and his cousin's daughter. In addition, he took the Child Tax Credit, Additional Child Tax Credit, and the Earned Income Credit. The IRS disallowed the Head of Household status and also refused his claims for dependency exemption deductions as well as the before-mentioned credits. This resulted in deficiencies in Walker's tax returns.

Dependency Exemption Deductions

The tax code allows a taxpayer a deduction for every dependent the taxpayer has during the taxable year.[9] IRC §152(a) defines a dependent as either a qualifying child or a qualifying relative:

An individual is a qualifying child of a taxpayer when he or she meets these requirements: (1) the individual is a child of the taxpayer or a child of the taxpayer's child, or the

[7] TC Summary Opinion 2017-8
[8] TC Summary Opinion 2017-8
[9] IRC §151(c)

individual is a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of such relative, (2) the individual lives with the taxpayer for more than one half of the taxable year, (3) the individual is under 19 years old at the end of the taxable year (or if the individual is a full-time student that is under 24 years old at the end of the taxable year), (4) the individual does provide more than one half of his or her own support during the taxable year, and (5) the individual does not file a joint return with his or her spouse for the taxable year.[10]

Here, neither the girlfriend's son nor the cousin's daughter qualify as the taxpayer's qualifying child. Their relationships with the taxpayer were not included in those listed in §152. Therefore, Walker could not claim these children as his dependents under the qualifying child rules.

However, a taxpayer can also claim an individual as his dependent if the individual is a qualifying relative of the taxpayer. An individual is a qualifying relative if he or she meets the following requirements: (1) the individual is a child of the taxpayer or a descendant of such child; or the individual is the taxpayer's brother, sister, stepbrother, stepsister, father, stepfather, mother, stepmother, brother's son or daughter, sister's son or daughter, father's brother or sister, mother's brother or sister, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or the individual, other than taxpayer's spouse, lives with the taxpayer for the whole taxable year[11], (2) the individual's gross income is less than the exemption amount of $4,050[12], (3) more than one half of the individual's support during the taxable year is provided by the taxpayer, and (4) the individual is not a qualifying child of the taxpayer or of any other taxpayer during the taxable year.[13]

In Walker's case, he claimed dependency exemption deductions for his girlfriend's son and his cousin's daughter, believing that they were his qualifying relatives. However, for his cousin's daughter, the taxpayer could not either establish the amount of time she lived in his household or proved that he provided more than one half of the support to her. The

[10] IRC §152(c)
[11] IRC §152(d)(2)(H)
[12] Internal Revenue Service, Publication 501, Exemptions, Standard Deduction, and Filing Information for use in preparing 2017 Returns. Retrieved from https://www.irs.gov/pub/irs-pdf/p501.pdf
[13] IRC §152(d)

judge agreed with the commissioner and denied Walker's dependency exemption deductions with respect to the cousin's daughter.

For the girlfriend's son, Walker managed to provide sufficient evidence showing that the child lived with him during the whole taxable years in dispute and that he provided the child more than one half of the child's support.[14] Therefore, he could claim the girlfriend's child as his dependent. The judge granted Walker dependency exemption deductions for the child as a qualifying relative.

Child Tax Credit and Additional Child Tax Credit

Besides the dependency exemption deductions, Walker also claimed the Child Tax Credit and Additional Child Tax Credit. These credits are provided for in IRC §24. These credits, for the years at issue, generally allowed a credit of $1,000 against his or her taxable income for every qualifying child he or she has.[15] An individual qualifies as a qualifying child of a taxpayer needs to meet all the requirements as previously mentioned under the dependency exemption rules.[16]

As it was determined that Walker had no qualifying child with respect to his girlfriend's son and his cousin's daughter, he was not entitled to this Child Credit. The judge rules in favor of the IRS and denied Walker the Child Tax Credits and Additional Child Tax Credits.

Earned Income Tax Credit

The tax code allows certain taxpayers a credit against their taxable income if his or her earned income does not exceed a specific amount that is known as earned income amount. This credit is ruled under IRC §32 and known as the Earned Income Credit. A taxpayer is eligible for the Earned Income Tax Credit if he or she has a qualifying child or, in the case the taxpayer does not have a qualifying child, the taxpayer must live in the United State more than one half of the taxable year, is at least 25 years old in the taxable year, and is not

[14] This satisfies §152(d)(2)(H)
[15] IRC §24(a) and (c)(1)
[16] IRC §152(c)

a dependent of any other taxpayers.[17] The earned income amount is generally determined based on the number of qualifying children and the filing status of the taxpayer.[18]

Walker's earned income was determined to exceed the applicable earned income amount and therefore, disqualified him for the Earned Income Credit. Accordingly, the judge disallowed him to claim earned income tax credit.

Head of Household Filing Status

Another dispute, in this case, concerned the tax filing status of Head of Household. As discussed earlier, Head of Household status puts an unmarried individual in an advantageous tax bracket (as compared to those filing as Single), generally resulting in lower tax liability. Section 2 of the Internal Revenue Code provides the conditions that a taxpayer has to meet if he or she wants to elect the head of household status. Specifically, the taxpayer must be (1) not married at the close of the taxable year, and (2) maintain his home as a household of a qualifying child, a dependent, or the mother or father of the taxpayer. A dependent is either a qualifying child or a qualifying relative as defined in §152 of the Code.[19]

Walker was not married during the taxable year and he maintained the household he lived in during the taxable year. Therefore, he could elect Head of Household status if he also had a dependent that lived with him during the taxable year. Although it was determined that Walker had no qualifying child during the taxable year, his girlfriend's son met the conditions to be his qualifying relative.

Section 152(d)(1) provides that an individual is a taxpayer's dependent if (1) he or she has a relationship with the taxpayer as defined in section 152(d)(2), (2) has gross income less than the personal exemption amount, (3) receives more than one-half of the support provided by the taxpayer, and (4) is not a qualifying child of other taxpayers.

Available evidence in the case showed that Walker provided more than one-half of the support of his girlfriend's son and the child was not a qualifying child of any taxpayer. The child had no other source of income. The child's relationship with Walker is included in the

[17] IRC §32(c)(1)(A)(ii)
[18] IRC §32(b)(2)(A)-(B)
[19] *See* Dependency Exemption Deductions.

definition of §152(d)(2)(H) because he lived with Walker during the taxable year. Therefore, the child was dependent on Walker. Based on the foregoing, it can be concluded that Walker met all the conditions to file his tax return as a Head of Household.

Therefore, on this particular matter, the Tax Court disagreed with the IRS and allowed Walker to elect Head of Household status on his tax returns. However, it appears that there is a flaw in the judge's decision over the Head of Household status of the taxpayer, which is to be discussed in the following section.

The Tax Code Needs to be Read in its Full Context

Section 2 of the Internal Revenue Code provides the conditions for a taxpayer to claim the Head of Household filing status. At the same time, this section also sets some limitations that prevent a taxpayer from filing as Head of Household even though he may preliminarily meet all the requirements imposed by the code.

Section 2(b)(3) states that a taxpayer is not a Head of Household during the taxable year if he or she is a non-resident alien in any time of the year, or if the taxpayer has a dependent under §152(d)(2)(H). In other words, if an individual is qualified as a dependent of a taxpayer under section 152(d)(2)(H), and the taxpayer only has this individual as his dependent, the taxpayer is not eligible for Head of Household status.

Section 2(b)(3) also sets forth another limitation for the Head of Household status regarding the support requirement. Accordingly, a taxpayer is deemed to provide over one half of the support to his dependent during a taxable year if no other person contributes over one half of the support, the taxpayer contributes over ten percent of the support, and other individuals who contribute more than ten percent of the support agree to write a declaration that they will not claim the dependent on their tax returns.[20] Section 2(b)(3) states that if a taxpayer provides more than one half of the support to his dependent only because of the above-mentioned conditions, he is not entitled to the Head of Household status.

Coming back to the facts of the case, since Walker established that he provided over one half of the support to his girlfriend's child, the second limitation is not applied in this case.

[20] IRC §152(d)(3)

We will discuss the application of the first limitation. As discussed above, the child of Walker's girlfriend qualified as his dependent under §152(d)(2)(H), however, because of the first limitation set forth in §2(b)(3), Walker would not be eligible for the Head of Household status.

If the judge had taken into account of the limitations under section 2(b)(3), he would have agreed with the commissioner and denied Walker his Head of Household status. This article does not look into the reasons why the judge missed the limitations; however, it is more than likely that the judge would have changed his ruling if he had noticed the limitations. This is to emphasize the importance of reading a tax code in full context before interpreting the code. Due to tax law's complexities and its ever-changing nature, limitations and specials rules are very common in the tax code and could be unnoticed if a code reader does not exercise thorough reading.

In this case, the judge's ruling regarding Head of Household status cannot be reversed because the taxpayer chose small case procedure when he filed his petition. Small case procedure prevents the IRS from appealing the case although the IRS is more than likely to win the case if it is appealed.

Tax Court: Taxpayer Responsibilities and General Procedures

In general, in a petition with the U.S. Tax Court, a taxpayer has the burden of proof when the IRS determines deficiencies in the taxpayer's return.[21] That is, the taxpayer is responsible for proving that the determination of the Commissioner is wrong or erroneous.

In the case of any deficiencies, a taxpayer has two options: (1) pay the deficiency or (2) file a petition with the Tax Court. Generally, a taxpayer will choose to file a petition to the Tax Court because it does not require the taxpayer to pay the deficiencies before a ruling is determined. If the taxpayer chooses to file a petition with a U.S. District Court, or U.S. Court of Federal Claim he or she will have to write a check for the determined deficiencies before the petition can be filed.

The Tax Court also allows a petitioner to potentially file small case claim, which was used by Walker. In order to file a small case claim with the Tax Court, the disputed amount

[21] Tax Court Rule 142(a)

(including interest and penalties) must not exceed $50,000. Small cases provide for a simpler and faster trial with fewer formalities than regular case petitions. However, once a ruling is given for a small case, neither party can appeal the decision.

This can help explain why the IRS Commissioner did not appeal the case and Walker was allowed to file as Head of Household, although the judge appeared to overlook the limitations of section 2(b)(3) and made a wrong decision over the matter.

Recap

Tax deductions and tax credits are a matter of legislative grace. That means a taxpayer cannot claim any deductions or credits unless they are lawfully allowed by the tax code. As a corollary, a proper interpretation of the tax code is imperative for a taxpayer to determine his or her eligibility for any tax deductions or credits. Likewise, a taxpayer has to comply with the tax code when he determines his tax filing status.

In Walker's case, he failed to substantiate his claims for dependency exemptions, Child Tax Credits, and Additional Child Tax Credits and Earned Income Tax Credits. Also, as discussed, although the Tax Court allowed Walker to file as Head of Household, he should have been denied this status. As a result, this failure of substantiation resulted in additional taxes for Walker.

Underpayment of tax may also lead to penalties and interests. Interests start to accrue from the due date for tax payment and will continue to accrue to the date the taxpayer pays the tax deficiencies. If a taxpayer decides to bring his case to the Tax Court before paying the deficiencies and does not prevail in the end, he will accumulate more interests. In order to fully comply with the tax code, a taxpayer should maintain a good record of documents relevant to their tax standing. If a taxpayer does not fully understand their tax position, it is recommended that the taxpayer seek advice from a professional and experienced practitioner.

Summaries for the 33rd Annual TEI-SJSU High Tech Tax Institute

Held on November 13th and 14th, 2017 at Crowne Plaza Cabana, Palo Alto, California

Authors: Silin Chen, June Hostetter, Sahdia Saiara, Jessica Wong, and Cherry Zheng.

Note: The analysis presented in the summaries does not reflect changes made by the Tax Cuts and Jobs Act of 2017.

Accounting for Income Taxes – Impact from Possible Tax Reform

By: Silin Chen, *MST Student*

A panel of experts in accounting for income taxes provided the audience with tax reform considerations on different types of entities with multiple items that could be affected, and how each type of entity and each item should be treated or considered before the passing of tax reform. Since the likelihood of the passing of tax reform is high, as predicted by tax professionals, entities should be prepared for the impact of tax reform.

Because the federal tax reform bill had not passed at the time of the conference, the information and advice provided at the panel were more general. Each entity should consult with advisors about their individual cases.

The panelists were Jesus Ochoa from PwC, Perry Leslie from KPMG, Tyler Spalding from Deloitte, and JJ Schneider from Grant Thornton.

Changes to the Corporate Tax

For the changes to the corporate tax, the financial accounting impact date will be the date the President signs the bill into law. The most important date to pay attention to will be the effective date because there could be multiple effective dates for different items. Each company's interim period report can also be affected due to the change.

According to the new information related to the tax reform[1], the date of the change could be prior to the end of the 4th quarter in 2017. If the signature happens before December 31st, accounting firms will have to spend a lot of time preparing the paperwork, and businesses will have a short amount of time to plan accordingly. Even though the bill has not been signed, all business entities should start to consider the effects of the possible

[1] U.S 115th Congress (2017-2018). H.R.1- *Tax Cuts and Jobs Act*, House Ways and Means Committee. Retrieved from https://waysandmeansforms.house.gov/uploadedfiles/bill_text.pdf

items in the tax bill because once it gets signed, there may not be enough time to adjust to the changes.

The reason that the tax reform is so complicated is that there are many different political powers involved in forming the content and pushing it through. However, likely tax reform will not take long to pass because it has received great support from the Trump administration. The hottest topic during the election that the President talked about was the reduction of the corporate tax rate to 20%. Business entities should understand what the actual effects of the tax rate change are, rather than just focus on the 20% tax rate. After all, there are other changes in the pending bill in addition to the tax rate reduction – including its impact for financial accounting purposes. The calculation and use of deferred tax assets and deferred tax liabilities, earnings per share calculation, and many other items will all be impacted with federal tax reform. Entities should understand both GAAP and non-GAAP perspectives.

Furthermore, for corporations having a tax year end other than the calendar year-end, they might have a more complicated situation because of possible further changes.

Carryforward of NOL

The current law allows a carryforward of a net operating loss (NOL) for a period of 20 years. However, the new law might change the length of the carryforward period. Entities should start to evaluate their NOL situation to see how much impact any changes would have. They should be prepared that some NOLs might not be used if they cannot generate enough income during any new potential carryforward period.

Executive Compensation

Both the House and Senate proposals contain changes on executive compensation, and certain types of compensation could be non-deductible. The House has proposed to remove the existing rules about nonqualified deferred compensation and create a new set of rules on this subject matter. In addition, both the House and the Senate have proposed to eliminate the performance-based compensation exceptions and expand the definition of covered employees of IRC §162(m) for certain corporations. Even though the final bill regarding compensation has not been confirmed, entities should anticipate what types of compensation are expecting limitations on their deductibility. There are possible changes to the taxation of stock options as well. For example, the performance-based exception under Code Section 162 for trade or businesses expenses may be repealed. If it is enacted, public companies will not be able to deduct its expense on such performance-based compensations, such as stock options. Silicon Valley companies, where stock options are very common to the employees, should immediately assess the effect the impact on their taxes if they have not already done so. The changes in stock compensation could have a big impact on their deferred tax assets and deferred tax liabilities.

Limitation on Interest Deductions

An interest deduction limitation of 30% of adjusted taxable income was proposed. It would affect a lot of companies that currently would be in a tax loss position instead of a profit position after deducting their interest payments. If implemented and a business was not able to fully deduct its interest in the current year, the remaining balance could be carried forward for a limited period. The House has proposed a five-year carryforward period for the suspended interest expense, whereas the Senate bill suggests having a one-year delay in the change.[2] For companies who have a history of losses and carryforward losses, they need to calculate how this limitation could affect their tax situated if enacted.

Permanent Reinvestment Assertion

A lot of large corporations have stored their cash offshore to avoid the high US tax rate upon repatriation. These US corporations will generate income through controlled foreign corporations and keep the cash overseas to avoid tax on such income. They usually do not have to pay tax until they repatriate the cash from overseas to the US. If the US corporation has maintained foreign earnings and profits (E&P), the bill will affect their potential taxation. They might still be able to claim some foreign tax credits to offset the mandatory repatriation tax. However, the new bill could have more strict repatriation regime, making Subpart F income harsher than it is currently. Some corporations might consider taking the

[2] Jim Tankersley, Alan Rappeport, and Thomas Kaplan. The New York Times. https://www.nytimes.com/2017/11/09/us/politics/facing-math-trouble-house-panel-races-to-adjust-tax-bill.html

cash back to the US. Entities should start as soon as possible to have advisers calculate the consequence of the change, such as building a model to evaluate their tax situation with foreign affiliate E&P. A few categories to consider are cash balances versus non-cash balances for the E&P of the controlled foreign corporation (CFC), if the E&P had been accumulated before 1986, unreported liabilities with possible repatriation, and the Fin48 position versus tax return position.

Accounting Method Change, Deferred Tax Liability Identification, and Reporting Time

Because tax reform is likely to be enacted, some businesses might consider potential accounting method changes as well in their tax reform preparations. As mentioned above, some of the credits or deductions that are available right now (e.g. the foreign tax credit) might not be available to certain taxpayers after the tax bill is enacted. Acceleration of the use of these credits and/or deduction (if possible) could be beneficial since they might not be used for taxable income reduction after the new law is passed.

When the entities make any accounting method changes, they should think about when they want the changes to be effective. For example, if they would like to file a non-federal change, they should file in the 4th quarter of 2017.

Conclusion

The four items the panelists mainly discussed were: (1) the corporate tax rate, (2) executive compensation, (3) limitation of interest deductions, and (4) un-repatriated foreign earnings. There were other topics contained in the material package that was defiantly worth reading, however, they were not discussed by the panel due to time constraints. Overall, the new bill will impact a lot of items for many businesses. All businesses should be proactive to evaluate the potential effects of both their overall financial statements and specifically on the tax provision side. Once the bill is passed, accounting firms will have limited time to organize and calculate the correct financial reporting amounts based on the new law, especially for entities with fiscal years.

Supply Chain Planning

By: June (Yun) Hostetter, CPA, *MST Student*

A panel of tax professionals from accounting and law firms discussed a changing and shifting environment and its impact on supply chain planning. The panelists were Bart Bassett from Morgan Lewis, Long Hua from Ernst & Young, Jimmy Man from Deloitte Tax, Taylor Reid from Baker McKenzie, and Brian Pedersen from Alvarez & Marsal who highlighted implications on state and local taxes (SALT) front. Mr. Pedersen delivered on the State side while the other speakers addressed the Federal side of the taxation. The panel focused on the issues that are driving and shifting the tax landscape, such as BEPS (Base Erosion and Profit Shifting) - especially Action 7, Brexit, and U.S. tax reform, and how supply chains could be affected and planned. Mr. Bassett described how the major shift driven by the Organization for Economic Co-operation and Development (OECD) was changing BEPS and its landscape. Also, Brexit had broad implications for U.S. based multinational companies doing business in the United Kingdom. Next, Mr. Hua said that multiple jurisdictions have adopted certain standards from other countries. Foreign countries will respond to U.S. tax reform based on the direction that U.S. tax reform goes. Finally, Mr. Man contemplated that some companies will just take a wait-and-see approach while dealing with uncertainty.

Buy-Sell Conversions

The panel responded to the changes of the Permanent Establishment (PE) standard [1], which was summarized by BEPS Action 7. By preventing the artificial avoidance of PE status, Action 7 may lower the threshold of the establishment of a PE and therefore result in the creation of more PEs.[2] Businesses should assess the potential impact and recommend changes to their supply chain structure.

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[1] Permanent Establishment (PE) is defined in Article 5 of the OECD Model Tax Convention. It basically means a fixed place of business through which the business of an enterprise is wholly or partly carried on, includes a place of management; a branch; an office; a factory; a workshop; and a place of extraction of natural resources.
Retrieved from: https://www.oecd.org/tax/treaties/1914467.pdf

[2] Preventing the Artificial Avoidance of Permanent Establishment Status, BEPS Action 7 – 2015 Final Report, OECD
Retrieved from: https://read.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en#page1

Mr. Reid presented several responses to the new PE standard raised by BEPS Action 7. The responses included "do nothing" or "declare a PE." The "do nothing" approach can be effective for the countries that do not adopt PE standard changes. "Declare a PE" is simply to accept and report PE in tax return filing. Both responses were rather wait-and-see approaches hoping that there would be further updates on the issue. More proactive responses were to convert from a foreign subsidiary or distributor of a U.S. parent company to a branch or reseller of a U.S. parent company. The most popular response by jurisdictions according to Mr. Reid was to convert to a reseller. Australia is a good example. It is because the reseller model shows more transparency in regard to revenue and Action 7 PE standard. Resellers should deal with customers directly, negotiate pricing, and act on their own behalf rather than as an agent. The independent local reseller structure may help to minimize the risk of meeting the PE requirement in a direct, large sales environment. This structure should be ideal for the sales of goods. However, it may not be ideal for the resale of services. Mr. Reid explained a recent case in India involving the reselling of services. National Geographic has an affiliated entity in India, which is engaged in buying and selling advertising in the U.S. The court determined that the entity is not a reseller because the entity is not selling tangible goods and the services are provided by the U.S. entity. Since the Indian entity acted as an agent for the U.S. entity, the U.S. company has a PE in India.

There are other challenges in this area as well, such as related party transactions and its Subpart F treatment if a business chooses to convert to a reseller. The panel continued to discuss Subpart F issues later in the session.

Mr. Pedersen reminded the audience that states do not generally follow the concept of PE. States have a similar concept called nexus. On the inbound side, states use nexus to determine whether there is a nexus to impose a tax on an out-of-state company. On the outbound side, taxpayers have PE for a jurisdiction, or even if they don't have PE, they may have a nexus for throwback or compliance purposes. U.S. branches are generally included in state tax return whereas foreign subsidiaries are not.

Digital Supply Chain Implications and Considerations

Mr. Hua pointed out that digital services were initially provided as an accessory to physical goods (e.g., smartphones) but eventually became their own stand-alone services. Digital services became one of the major issues in supply chain planning. There are many questions that businesses who provide digital services should ask to determine their PE status in a particular jurisdiction, such as: Who is the principal of the contract? Is it the U.S. parent, a local entity (in buy-sell type situations), or is a cloud operator the principal of the digital services? To provide digital services, the U.S. parent company may own the cloud operator with a data center anywhere in the world. Data center ownership could be a cause for a PE exposure. If so, an important fact is where the actual server is located. A physical location of the actual server may create PE in the specific jurisdiction. Essentially, any physical placement of server to a physical location could trigger a PE. If a business has a PE, the next question will be on how to attribute profits from the sale of the services. For example, suppose a company places a physical server in Sweden and provides services worldwide. Assuming that a PE has been established in Sweden, we may wonder how much profit should be attributed to the non-Swedish jurisdictions in which it operates.

In regard to renting a server, instead of owning it, the panel had a consensus that renting servers using third-party providers like Amazon Web Services (AWS) and Microsoft services should not create a PE. If a business has no control or access to the server or data center, it is safe to say that there is no PE.

Mr. Pedersen added that there was no physical presence requirement for sale and use tax purposes in states like Alabama and South Dakota. These states were adopting economic nexus rules that were applicable for income tax but extended them to sales and use tax. He briefly discussed the issue of economic nexus laws that were technically unconstitutional per *Quill* due to the Supreme Court decision in 1992.[3] States hoped that *Quill* would be

[3] *Quill Corp. v. North Dakota, 504 U.S. 298 (1992)*

overturned by the Court soon.[4] Also, many states are moving towards market-based sourcing methods when assessing a business income tax. The physical location may not be as important as it used to be to determine tax liability in states.

Subpart F Challenges

Another main issue that the panel discussed was Subpart F challenges. Part of Subpart F in the IRC is a provision that eliminates deferral of U.S. tax on foreign income earned by controlled foreign corporations (CFC).[5]

A manufacturing exception provided for in Treas. Reg. §1.954-3 was one of the Subpart F exceptions regarding the U.S. taxing of the foreign supply chain. The income of a CFC in connection with a sale of personal property manufactured by the CFC will be excluded from Subpart F treatment. To be qualified for the manufacturing exception, a CFC needs to satisfy one of the three tests: (1) substantial transformation, (2) substantial activities, or (3) substantial contribution.[6]

Mr. Bassett explained that the substantial contribution test is relatively new, but the test is broadly used due to the growth of the global workforce. The global workforce creates opportunities for people around the world to participate in the supply chain. Treas. Reg. §1.954-3(b) lists seven activities to be considered as a substantial contribution. However, even if a business qualifies under the substantial contribution test, it may fall under the branch rule of IRC §954(d)(2). The branch rule says if a CFC uses a branch outside their country of incorporation and it would have substantially the same effect as if the branch were a wholly owned subsidiary, then the branch is a separate CFC.[7] Income from the foreign branch is treated as income from the wholly-owned subsidiary. Thus, it will be

[4] *South Dakota v. Wayfair, Inc., 585 U.S. (2018)*. Subsequent to the presentation the Supreme Court overturned *Quill* by allowing states to collect sales and use taxes from out of state businesses even if they do not have a physical presence in the state. The Court granted a writ of certiorari in January 2018 and ruled in favor of South Dakota on June 21, 2018.
[5] Subpart F is comprised of IRC §§ 951-965. An overview can be found at: https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF (Internal Revenue Service)
[6] Reg. §1.954-3
[7] IRC §954(d)(2)

added to foreign base company sales income of the CFC. The purpose of the branch rule is to go after the global mobile income of CFCs.

U.S. Tax Reform and Other Issues

Mr. Man briefly reviewed key provisions between House and Senate bills. The key points in the supply chain area would be 100% dividend received deduction (DRD) from dividends received from certain foreign affiliates, a possible tax break on repatriated earnings, no repeal of the current Subpart F regime, and a potential 20% excise tax on payments from U.S. corporations to their foreign affiliates. Both House and Senate bills would create three trillion-dollar deficit in 10 years.

Mr. Pedersen addressed that federal tax reform would affect state taxes in a number of states based on the extent of capital expensing of assets and the repatriation rate at the federal level. Many states are already decoupled from federal tax provisions such as bonus depreciation, foreign tax credits, DRD, and Subpart F. Also, repatriated earnings may get a tax break on the federal side, but there may potentially be no break on the state side. It would be unlikely that states would adopt federal provision and lower their tax rates. However, things are very uncertain. Mr. Pedersen explained that the current state tax landscape was more uncertain than the 1986 Tax Reform Act era. Thus, anything could happen.

Conclusion

As the panel pointed out throughout the session, the shifting environment in the current developments of BEPS, Brexit, and U.S. tax reform is impacting supply chain planning. The panel also briefly discussed the efforts of the IRS on LB&I inbound campaigns and IRC §482 changes. The agenda for the panel was very broad, so the panel admitted from the beginning that there may not be enough time to cover all the proposed agenda. Overall, the panel covered significant issues that require extensive research and deep discussion. Considering the uncertainties that the business is facing, it is important for tax professionals to monitor the current developments and inform their clients accordingly.

Tax Automation Discussion Summary

By: Sahdia Saiara, *MST Student*

Amongst all the interesting topics discussed at the 33rd Annual TEI-SJSU High-Tech Tax Institute, I chose to summarize "Tax Automation." The topic was very intriguing to me because technology has been evolving more than ever in the last couple of decades and it is only a matter of time that trends in tax technology, artificial intelligence and robotics will bring radical changes to the corporate tax world. The panelists who brought their valuable insights into this subject were Andy Ruggles (moderator), Partner with PwC and National Practice Leader of Tax Reporting & Strategy, Danyle Ordway, Partner with Ernst & Young and head of Tax Technology and Data Analytics, John Viglione, Executive VP at Vertex and last, but not least, Rafiq Jalal, Managing Director of Tax Technology at KPMG.

Mr. Ruggles focused on the following key trends in tax technology and operations and tax automation ties into these trends:

- Technology is only one of the pillars for achieving automation. The other pillars are data management, process designing, and manpower.
- Through tax automation, companies are trying to achieve increased efficiency and connectivity to businesses as well as risk management, such as material weaknesses in financial statement reporting.
- Companies nowadays are going through big transformations that are dedicated to "targeted solutions via proof of concepts."[1]
- The application and effect of tax automation will vary throughout functional areas, such as sales tax, property tax, income tax, etc.
- By implementing systems like SAP and Oracle, companies are transforming into cloud-based finance systems.
- Another key trend in tax technology among non-U.S. countries is that they require transparency in achieving automation. For example, companies are required to

[1] Ruggles, Andy, et al. "Tax Automation Discussions." 33rd Annual TEI - SJSU High Tech Tax Institute, 14 Nov. 2017.

submit their trial balances, invoices, and receipts electronically to Mexican tax authorities.

- Robotics is making its way into the labor force in tax functions.

Finally, Mr. Ruggles talked briefly about the following parts of the tax ecosystem and the scope for tax automation in each part

- Enterprise source systems are where the data is housed for core financial systems, i.e., SAP, Oracle, etc.
- The Extract, Transform and Load (ETL)/data hub is where the data is organized and prepared for the tax team. Vertex has a solution for tax automation in this area, which is discussed later in this summary from Mr. Viglione's perspective.
- Tax application is the classic income tax and tax provision software solutions, i.e., CorpTax, OneSource, etc.
- Business intelligence (BI) helps create an analytics layer for the tax function, i.e., Power BI, Tableau, etc.
- Tax operations management is a portal used by some organizations to manage tax operational considerations.
- Robotic Process Automation (RPA)/digital automation is part of process automation using robots as well as people.

In the next part of the presentation, Ms. Ordway talked about the potentials of RPA in the world of tax. She explained RPA as reducing manual data manipulation by mimicking human interaction. In today's world, there is a substantial amount of cost savings in the finance world using RPA, but there still is no implementation of it in tax. Ms. Ordway suggested that the simple but tedious and time-consuming projects could be powered by RPA. The downside is that since these are code-bots rather than actual (physical) robots with artificial intelligence, they are only capable to perform "if-then" functions. However, the bots are able to act as an employee and sit on top of the tax ecosystem discussed above to perform all the otherwise time-consuming tasks such as data collection, analysis, organization, reconciliation and even provide password protection. Therefore, besides day-to-day functions, the bots can be used in audits for collecting and organizing data asked by the auditor. Furthermore, the bots are inexpensive, easy to implement, does not require IT involvement and are able to work around the clock. Lastly, human error can be minimized, and efficiency can be multiplied tremendously using RPA.

Next, Mr. Viglione brought in his perspective of a tax technology vendor. Technology vendors have three key design considerations. The first one is that everything has to be digital that is all-inclusive. The motive behind digitalization is to centralize data and to tie it all together, which was the intention behind launching the data hub concept of Vertex Enterprise. Secondly, vendors focus on complete and utter transparency and discoverability of data starting from the discrete transaction point. Transparency is not only important to the organization itself, but also for the government as discussed above in the Mexican government's example. The last consideration for vendors is to build intelligence into solutions that are augmentative. This third vendor consideration is expanded below from Mr. Jalal's perspective.

Mr. Jalal gave his insight on emerging technologies such as Blockchain and artificial intelligence (AI). He built upon the concept of RPA in tax discussed above and suggested that some decision-making processes may also be automated in the near future. His discussion included the following functional aspects that have helped tax software programmers evolve:

- Tax professionals need the data in a structured and organized way for maximum efficiency, which can be achieved by technology.
- The past and current technology were focused on descriptive analytics, such as pie charts, bar charts, etc. However, AI will help develop predictive and perspective analytic skillset in tax technologies.
- Big data or data that is so enormous and convoluted that makes processing applications incompetent, used to be a challenge. However, that hurdle has been overcome for the most part and solutions can now be applied in tax as well.

- Cloud computing is commonly mistaken as merely a data center, but it is much broader than that. Cloud computing can not only enable data storage, but also the over-the-Internet delivery of computing services, such as servers, databases, networking, software, analytics, etc.[1]

Lastly, Mr. Jalal discussed how Blockchain is becoming a more and more popular network of transactions because it enables transparency. The same concept can also be implemented in tax in the future, where tax, accounting, and financial transactions may be recorded in Blockchain so that the organization and government both have access to it.

The discussion overall was very informative and encouraging since the focus of tax automation is to increase efficiency and reduce stress. Other functions of business, such as finance, is already enjoying the benefits of automation and shaving hundreds of valuable hours from completing repetitive, tedious processes. The hope is to bring automation into the tax world to put human labor into better use.

Domestic and Multistate Update

By: Jessica Wong, *MST Student*

On November 14, 2017, Diana Lance from Grant Thornton, LLP and Joshua T. Brady from Morgan, Lewis & Bockius LLP. discussed an update of domestic and multistate tax law at the 33rd Annual TEI-SJSU High-Tech Tax Institute in Palo Alto, CA. State tax laws continue to remain complex despite the clarification of the tax law that many states are currently undertaking, updates and clarification to the tax laws will continue to be needed in a rapidly changing economy.

Multistate Update

A significant update on the multistate front is the apportionment rules regarding market-based sourcing in several states that impact how taxpayers report their sales connected to these states. Several states issued a clarification on their rules in this area.

California

The California Franchise Tax Board (FTB) released Chief Counsel Ruling (CCR) 2017-01[1] for health plan companies. In this ruling a health plan servicing company (taxpayer) enters into a health service plan agreement with its health plan customers (health insurers, employers, unions, etc.), to provide health insurance administrative services to both its direct health plan customers and the ultimate health plan employees/members. However, under market-based sourcing rules, health service companies were confused about who receives the benefit when a taxpayer receives income from a subcontracting service company in these types of situations. The FTB addressed the assignment of the sales income, utilizing the guidance set forth under California Rev. and Tax. Code Section 25136[2] and the regulations[3] thereunder, as follows:

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[1] Chief Counsel Ruling 2017-01. Retrieved from: https://www.ftb.ca.gov/law/ccr/2017/01.pdf
[2] *See* Cal. Rev. & Tax. Code § 25136(a)(1)
[3] *See* Cal. Code Regs., tit. 18, § 25136-2(b)(1)

- The health plan service company's sales of its services are sourced to California to the extent that its direct customers (i.e., the health plans), and not the ultimate members, received the benefit from the taxpayer's services in California.
- The benefit received by the health plan is the relief of the obligation to perform the business functions required under the health plan agreements and,
- The taxpayer will assign sales of its services to California if the health plans receiving the benefit are located in California.

Therefore, based on these rulings, the updated law is meant to clarify how health service's sales income will be allocated to California. However, the actual application may lead to additional complications.

Other States

During 2016 a Connecticut (CT) law was enacted whereby gross receipts from services are assignable to CT if the market for the services is in that state. Similar to California, CT issued guidance for subcontractors but stated that the benefit would be allocated to the ultimate customer (the direct customer's customer) and not the direct customer. CT issued Special Notice 2017(1)[4] with 28 transaction samples to provide taxpayers guidance on how certain sales under market-based sources are included in a state's sales factor.

On May 3, 2017, Montana enacted legislation that revised their Multistate Tax Compact provisions, based on the recommendation of the Multistate Tax Commission, to adopt market-based sourcing for sales of nontangible personal property. This new rule will begin for tax years beginning after December 31, 2017.

Another state that will be adopting market-based sourcing is Oregon. Effective for tax years beginning on or after January 1, 2018, under this new rule sales of services and intangible property will be subject to market-based sourcing. However, this change will not be applicable to financial organizations, utilities, and telecommunications businesses.

[4] Special Notice 2017-1, *Legislative Changes Regarding Single-Sales Factor Apportionment and Market Based Sourcing*. Issued: April 17, 2017. Retrieved from: http://www.ct.gov/drs/lib/drs/publications/pubssn/2017/sn2017-1.pdf

This law is still in work in progress and taxpayers should expect more guidance in the future.

Nexus

With more companies doing business out-of-state, nexus continues to be a hot issue in multistate taxation. Ms. Lance concluded that states are becoming more assertive regarding the collection of taxes from out-of-state businesses. She discussed a few disputes between taxpayers and states. Two of these are presented below:

Aventis Pharmaceuticals, Inc.[5]

Aventis Pharmaceuticals, Inc. is protesting a decision from the New Mexico (NM) Taxation and Revenue Department. The issue for this case is whether or not the taxpayer is protected under P.L. 86-272[6] and the Commerce Clause.[7] The state concluded that the taxpayer's activities went beyond the mere solicitation of sales, and therefore, they were not protected by P.L. 86-272, as their activities increased their market and its potential market in the state. Aventis Pharmaceuticals' activities in the state consisted of the solicitation of sales, providing doctors with ongoing education, clinical trials, textbooks, training material funding, and classes at doctors' offices.

Capital One Auto Finance v. Department of Revenue[8]

In this case, it was ruled that Capital One Auto Finance (taxpayer) was subject to corporate income tax in Oregon. Although the taxpayer did not have a physical presence in the state, their activities in the state included the solicitation of Oregon customers, extending credit, the loaning of money, pursued collections, and utilized the court system in Oregon. Additionally, this case concluded that subjecting a financial institution to income tax was not a violation of the Commerce Clause.

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[5] Docket/Court: 17-23, New Mexico Taxation and Revenue Department Decision and Order. Retrieved from: http://www.tax.newmexico.gov/tax-decisions-orders.aspx?9674a2e28c1442ce8b25e81c6d015418blogPostId=57eb48770db7427f8c413afa1016cd64

[6] *Public Law 86-272* is a federal law which prohibits a state from imposing a tax based on income (directly or indirectly) upon a taxpayer whose only activity within the state is "solicitation" of orders for the sale of tangible personal property, where the orders are approved, filled and delivered from a stock of goods located outside the state. Retrieved from:

[7] *The Commerce Clause* of the U.S. Constitution protects trade between states from facing possible double taxation, discrimination against out-of-state business, and taxation of other interstate and multistate activities.

[8] Capital One Auto Finance v. Department of Revenue, OR. TC 5197 (12/2016)

Tax Rate Updates

Ms. Lance later informed the attendees that the following states will be updating their corporate tax rates:

- The District of Columbia corporate tax rate for 2018 will change from 8.75% to 8.25% because the state has met its revenue targets.
- North Carolina will expect to receive a reduced corporate tax rate from 3% to 2% beginning on or after Jan 1, 2019.
- The Illinois corporate tax rate will increase from 5.25% to 7%, effective July 1, 2017.

These updates will have an impact on companies that are filing state tax returns in these regions. The D.C. and North Carolina changes in rates demonstrate that some state governments respond to the revenues they are receiving by adjusting their corporate tax rates if they meet their targeted revenue requirements.

Domestic Tax Updates – Mergers and Acquisitions

The second half of the presentation was from Mr. Joshua T. Brady, who discussed updates on domestic tax in regard to mergers and acquisitions.

IRC §385 Regulations[9] – Updated Status

Mr. Brady provided the following updates for regulation under IRC Section 385:

- Notice 2017-36: Under this notice, the effective date for Reg. §1.385-2, regarding the documentation rules, has been delayed applying to certain instruments entered into between related parties on or after January 1, 2019.
- Notice 2017-38: The IRS intends to modify or repeal regulations under Section 385, which also includes the Reg. §1.385-3 recharacterization rules.

He noted that the reason for the delayed changes is because the rules under IRC Section 385 are very extensive. However, though these regulations are not finalized, Mr. Brady questions if tax reform will intervene with these rules. The speaker foresees a possibility that new information regarding the status of the 385 Regulations is yet to come.

[9] IRC §385 provides guidance on the treatment of certain interests in corporations as stock or indebtedness.

Withdrawal of the 2005 Proposed Net Value Regulations

The following are the issues that arise from these regulations for the purpose of mergers and acquisitions:

- Section 351 tax-free incorporation transfers: This regulation created two issues to IRC §351. First, how should the transferor transfer the net value when the value of an asset, such as stock, is worthless. Second, should the transferor be solvent after the transfer? Under the current law, the transferor must be solvent, but Mr. Brady disagrees with this current law.
- Section 332 liquidations: Under this regulation, the distribution of assets must be in accordance with the liquidation plan.[10] However, Mr. Brady foresees an issue that if a company acquires a corporation with worthless stock would the value of the stock be disregarded?[11]
- Section 368 reorganizations: Mr. Brady points out that there are two conflicting rules that contradict §368 requirement if the acquiring company must be solvent after the reporting the reorganization. First is from *Norman Scott, Inc. v. the Commissioner*[12], where the acquiring company is not required to be solvent. The second is from Rev. Rul. 59-296 that require the similarly situated acquiring company to be solvent.

According to Mr. Brady, involving these regulations with a merger and acquisition under these circumstances may add additional complications.

Conclusion

Though the panel highlighted several changes that are expected in the future, it is apparent that these changes require a large amount of time and consideration from the state tax authorities. There are issues in the new guidance associated with these changes that need to be addressed. Additionally, there are regulations that are considered outdated that require tax authorities to update them to adapt to a rapidly changing economy. Tax laws

[10] IRC §332
[11] IRC §368(a)(1)(C)
[12] Norman Scott, Inc. v. The Commissioner, 48 TC 598 (1976)

require guidance because as a colleague to Mr. Brady stated, "unlike fine wine, most regulations do not get better with time."

IP Location Planning

By: Cherry Zheng, *MST student*

With continuing developments in technology comes more and more high-tech companies. Intellectual Property (IP) is the cornerstone of many high-tech firms, which makes companies pay more attention to IP tax planning, especially in the Silicon Valley. In this panel, a number of experts from accounting and law firms discussed several key considerations of IP location planning, IP structures and trends in different jurisdictions. The speakers were William Skinner from Fenwick & West LLP, Pie Geelen from DLA Piper, Gabe Gartner from PwC, Jon Davies from Armanino LLP and Nathan Giesselman from Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates.

Overview of IP Location Planning and Key Considerations

This first discussion covered fundamental IP location considerations, including tax treatment in the jurisdiction of IP holding companies as well as the overall tax treatment in the US and other countries. With changes and increased uncertainty in recent years, IP location strategies have changed accordingly. Here are some key considerations discussed by the panel:

- Tax Rates and Incentives in IP Jurisdictions
- Base erosion and profit shifting (BEPS) and Development, Enhancement, Maintenance, Protection and Exploitation of intangibles (DEMPE) functions
- Country-by-Country Reporting (CbC Reporting)
- Anti-Avoidance Legislation:
    - UK's Diverted Profits Tax (DPT)
    - Australia's Multinational Anti-Avoidance Law (MAAL) and DPT
- EU Considerations:
    - State Aid
    - Anti-Tax Avoidance Directive (ATAD I and II)[1]

[1] Skinner, W., Geelen, P., Gartner, G., Davies, J., & Giesselman, N. (2017). *IP Location Planning*. The 33rd Annual TEI-SJSU High Tech Tax Institute. Conference Presentation. Retrieved from: http://www.sjsu.edu/taxinstitute/about/history/2017materials/IP_Location_Planning2.pdf

Next, we will next look into IP tax planning in more detail, focusing primarily on common legal structures in countries covered in the presentation.

Netherlands Structures

CV/ BV structures

A CV / BV structure is relatively common in practice in the Netherlands. It is used by many US multinational corporations to avoid tax on their non-US profits. In this set-up, a US parent sets up a Dutch limited partnership (CV), which holds all the shares in a Dutch operating company (BV). The BV usually acts as a holding company for non-US subsidiaries and the earnings of these subsidiaries are channeled via the BV to the CV as dividend distributions or payments of interest and royalties. The CV is not taxed on this income in any country because the CV is subject to neither Dutch nor US corporate income tax due to a mismatch in the classification of the CV in both the countries.[2]

IP Structuring Dilemma and Uncertainty

Although many already know some of the major changes in the global marketplace, there are still some uncertainties that will affect IP location strategies. For instance, DEMPE (to be discussed later) has been aligned with IP ownership but the interpretation is not cleared. The current US tax reform adds more uncertainty to the marketplace.

Under current changes and uncertainties, tax participants should consider whether their situations are suitable to locate their IP offshore or not, and if they decide to offshore their IP, should they utilize a one-tier or two-tiered entity structure.

Irish Structures

ATAD I and ATAD II

On January 28, 2016, the European Commission presented its proposal for an Anti-Tax Avoidance Directive (ATAD) as part of the Anti-Tax Avoidance Package and it was

[2] Jan Vleggeert. (2015). *What about CV-BV structures and state aid?* Leiden Law Blog. Retrieved from: http://leidenlawblog.nl/articles/what-about-cv-bv-structures-and-state-aid

approved by EU's Council on July 20, 2016.[3] The Council Directive (EU) 2016/1164 (ATAD I) contains five legally-binding anti-abuse measures, which all Member States should apply by January 1, 2019. The five measures include CFC rule, switchover rule, exit taxation, interest limitation and general anti-abuse rule.

In the following year, the EU's council formally adopted ATAD II, which is the amended Directive with a broader scope. The ATAD II should be implemented by January 1, 2020, by all the Member states.

Coffey Report

The Coffey Report is an independent report prepared by economist Seamus Coffey.[4] It was released on September 12, 2017, and detailed a number of proposals regarding Ireland's corporate tax code. It has recommendations on three key aspects of the international tax system: transfer pricing, intellectual property regime, and a territorial tax regime.

- Transfer pricing: It suggests that Ireland's transfer pricing rules should be updated to follow the 2017 OECD Transfer Pricing Guidelines. It agrees with 2015 BEPS Reports Actions 8-10 *Aligning Transfer Pricing Outcomes with Value Creation* and should be implemented by January 1, 2021.
- IP amortization regime: It recommends a cap that only 80% of income can be offset by capital allowances for intangible assets and any related interest expense and the balance can be carried forward.
- Territorial tax regime: It recommends Ireland to adopt a territorial tax system to be more competitive in the current international environment.

Singapore Structures

For U.S. multinational companies who are seeking for a location of an offshore holding company for their IP assets, Singapore is one of the top choices, especially for the IP-intensive companies. An IP holding company can centralize the IP rights to reduce the

[3] European Commission. Anti-avoidance Tax Directive. Retrieved from: https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en

[4] Seamus Coffey (2017). *Review of Ireland's Corporation Tax Code*. Retrieved from: https://www.finance.gov.ie/wp-content/uploads/2017/09/170912-Review-of-Irelands-Corporation-Tax-Code.pdf

ownership uncertainty by creating one central entity that holds the IP, automatically accrues the IP rights generated by any affiliated companies, and takes responsibility for IP filings, IP fundraising, and IP securitization.[5] Singapore has many advantages to be the location of IP holding companies. It has both a lower rate of 17% and completed and strong IP registration and protection laws. Although there are some zero-tax jurisdictions, compared to Singapore, it's easier to be audited by the home country and lack of protection of IP rights. At the same time, Singapore has a large tax treaty network and beneficial rules as well, which makes Singapore fits the role better.

U.S. Structures

This panel focused on some examples to interpret differences between US IP rules and those governed under BEPS. These differences are important, especially for companies with significant US development activities.

Transfer Pricing Rules

- Internal Revenue Code Sections 482 and 367

  Section 482 establishes the arm's length standard and states "in the case of any transfer of intangible property, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

  Treas. Reg. Section 1.482-7(g) provides special methods for transfers of platform contribution transactions (PCTs) to an R&D cost-sharing arrangement (CSA), including the income method/investor model, the comparable uncontrolled transaction method, and the acquisition price method.

  Section 367(d) is designed to impose tax consequences on an outbound transfer of intangible property similar to the tax consequences that would have been imposed on an outbound license of intangible property in consideration for a royalty subject to Section 482.

  Under Section 367(d)(2)(A), a U.S. taxpayer transferring the intangible property to a foreign corporation is treated as:

[5] Stephen Roberston (2017). *5 Ways an IP Holding Company Could Benefit Your Business.* Retrieved from: http://metispartners.com/2017/10/16/5-ways-an-ip-holding-company-could-benefit-your-business/

- "having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and
- receiving amounts which reasonably reflect the amounts which would have been received 1) annually in the form of such payments over the useful life of such property, or 2) in the case of a disposition following such transfer at the time of the disposition."[6]

- BEPS Action 8-10

BEPS Action 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, includes the transactional profits split method. It retains the 2014 guidance on categories of intangibles, transfer pricing methods, and important functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles (the DEMPE functions).[7]

Conclusion

This presentation identified several key considerations of IP location planning and current international and domestic updates regarding IP. With frequent changes in the tax environment, new developments of companies, and potential uncertainties, even experienced tax professionals are facing challenges and must keep working on better IP location strategies. Tax participants should be aware of the new trends and international rules to provide professional advice to their clients and help them build appropriate tax strategies.

[6] IRS Section 367 (d)(2)(A)

[7] OECD/G20. *Aligning Transfer Pricing Outcomes with Value Creation*. Retrieved from: https://www.oecd-ilibrary.org/docserver/9789264241244-en.pdf?expires=1532847943&id=id&accname=guest&checksum=D8F939C8B604EA0B1AFCE0C6F46CC8A2

Becker CPA Exam Review

CPA-01609 / Topic REG-01-03: Gross Income: Part 2

Title: PII Nov 93 #21

Perle, a dentist, billed Wood $600 for dental services. Wood paid Perle $200 cash and built a bookcase for Perle's office in full settlement of the bill. Wood sells comparable bookcases for $350. What amount should Perle include in taxable income as a result of this transaction?

A. $0

B. $200

C. $550

D. $600

Explanation

1. **Choice "C" is correct**. The $200 cash received plus the $350 fair value of the bookcase received must be included in income by Perle, for a total of $550. The income is based on the value in money or fair value of property received by Perle, not the $600 billed.
2. Choice "A" is incorrect. Perle must report taxable income as a result of this transaction.
3. Choice "B" is incorrect. The $350 fair value of the bookcase received is also income for Perle.
4. Choice "D" is incorrect. The income is based on the total value received by Perle, not the $600 billed.

CPA-02003 / Topic REG-02-01: Adjustments

Title: PII Nov 93 #28 (Adapted)

Davis, a sole proprietor with no employees, has a Keogh profit-sharing plan to which he may contribute and deduct 25% of his annual earned income. For this purpose, "earned income" is defined as net self-employment earnings reduced by the:

A. Deductible Keogh contribution.

B. Self-employment tax.

C. Self-employment tax and one-half of the deductible Keogh contribution.

D. Deductible Keogh contribution and one-half of the self-employment tax.

Explanation

1. **Choice "D" is correct**. For Keogh plans, earned income is defined as net self-employment earnings reduced by the amount of the allowable Keogh deduction and ½ the self-employment tax.
2. Choice "A" is incorrect. For Keogh plans, earned income is also reduced by ½ the self-employment tax.
3. Choice "B" is incorrect. For Keogh plans, earned income is reduced by ½ the self-employment tax, not the entire tax.
4. Choice "C" is incorrect. For Keogh plans, earned income is reduced by ½ the self-employment tax and the full amount of the deductible Keogh contribution.

CPA-06907 / Topic REG-03-02: Taxable and Nontaxable Dispositions

Title: AICPA Newly Released 2011

A married couple purchased their principal residence for $300,000. They spent $40,000 on improvements. After living in it for 10 years, the couple sold the home for $650,000 and paid $36,000 in real estate commissions. What gain should the couple recognize on their joint return?

A. $0

B. $60,000

C. $274,000

D. $310,000

Explanation

1. **Choice "A" is correct.** The sale of the taxpayer's personal (primary or principal) residence is subject to an exclusion from gross income for a gain of $500,000 married filing joint or $250,000 single. To qualify, the taxpayer must have owned and used the property as a principal residence for two years or more during the five-year period ending on the date of the sale or exchange.

Taxpayer's Basis:	300,000	Purchase price
	40,000	Improvements
	36,000	Real estate commissions
	376,000	Ending basis
Sales Price:	650,000	
Gain on sale:	274,000	Under allowed $500,000 exclusion for a married couple

2. Choice "B" is incorrect based on the above calculation.
3. Choice "C" is incorrect. $274,000 is the *realized* gain, yet it does not need to be *recognized*.
4. Choice "D" is incorrect based on the above calculation.

CPA-06003 / Topic REG-04-01: Corporate Formation

Title: Released 2009

In April, X and Y formed Z Corp. X contributed $50,000 cash, and Y contributed land worth $70,000 (with an adjusted basis of $40,000). Y also received $20,000 cash from the corporation. X and Y each receive 50% of the corporation's stock. What is the tax basis of the land to Z Corp.?

A. $40,000

B. $50,000

C. $60,000

D. $70,000

Explanation

Rule: There is no gain or loss to the corporation issuing stock in exchange for property for the issuance of stock. The general rule is that the basis of the property received from the transferor/shareholder is the greater of: (1) adjusted net book value of the transferor/shareholder plus any gain recognized by the transferor/shareholder or (2) debt assumed by the corporation.

1. **Choice "C" is correct**. X and Y form Z Corporation so that each receives a 50% interest in the corporation. X contributes $50,000 in cash, and Y contributes land worth $70,000 and receives $20,000 from the corporation [note that each has contributed a net $50,000]. Z Corporation will record the basis of the land at the basis of Y ($40,000) plus any cash it paid to secure the land ($20,000), or $60,000 total basis. Per the above general rule, the basis of the property received from the transferor/shareholder is the greater of: (1) adjusted net book value of the transferor/shareholder plus any gain recognized by the transferor/shareholder or (2) debt assumed by the corporation. As there is no indicated debt on the land nor any gain recognized by Y on the transfer [because X and Y own at least 80% of the voting stock immediately after the transaction, the basis is the adjusted net book value of Y ($40,000) plus any cash Z Corporation pays for the land ($20,000). [Note that we have *not* addressed the shareholder consequences in this question.]
2. Choice "A" is incorrect. The answer includes only Y's $40,000 basis in the land. Z Corporation will record the basis of the land at the basis of Y ($40,000) plus any cash it paid to secure the land ($20,000), or $60,000 total basis.
3. Choice "B" is incorrect. This answer option is the amount of fair market value each shareholder was to contribute to form the corporation at inception. Because Y contributed land worth $70,000, the corporation paid Y $20,000 in cash to make each shareholder contribute $50,000 in FMV of assets.
4. Choice "D" is incorrect. This answer option is the amount of the fair market value of the land at the date of transfer. Per the above general rule, the basis of the property received from the transferor/shareholder is the greater of: (1) adjusted net book value of the transferor/shareholder plus any gain recognized by the

transferor/shareholder or (2) debt assumed by the corporation. Refer to the calculation for answer option "C".

CPA-08467 / Topic REG-05-03: Partnerships: Part 2
Title: AICPA Newly Released 2014

Able, an individual, is a partner in CD Partnership with an adjusted basis of $30,000 for Able's partnership interest. Able received a non-liquidating distribution of $25,000 cash and property with an adjusted basis of $7,000, and a fair market value of $10,000. What amount of gain should Able recognize?

A. $0

B. $2,000

C. $5,000

D. $12,000

Explanation

1. **Choice "A" is correct**. Gain is recognized only to the extent that cash distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Able's basis in the partnership immediately before the distribution is $30,000. The cash distribution is $25,000. This is not in excess of basis and there is a $5,000 basis remaining. Able's basis in the distributed property is the $5,000 remaining partnership basis.

2. Choices "B", "C", and "D" are incorrect, per the above explanation.

Tax Maven

The Contemporary Tax Journal's Interview with Mr. Eric Ryan

By: Sara (Yaqin) Sun, *MST Student*

How did you get involved in the tax field? Was that your plan when you started law school?

I always wanted to be a lawyer, but I wasn't sure what field. I was pretty good at math, and I ended up getting an undergraduate degree in Accounting. When I started at UC Berkeley Law School, I saw that there were many interesting fields of law. But it became obvious that most students were not interested in Tax. Then I took and passed the California CPA Exam during a summer lull, and ultimately the employment picture was very favorable for the few of us interested in Tax, so that sealed the deal.

What led you to Apple, PwC and DLA Piper? What are your specialty areas?

I joined Apple in 1982 when that Company was only about five years old, as a Manager of Tax Research and Planning. It was growing very fast, profitable, and expanding overseas. Along with others, I helped Apple set up and defend its multinational legal entity and tax structure. My boss left after about two years, and I became Tax Director. Apple had an exciting environment of innovation, experimentation, and change-the-world attitude. I am not sure Apple's leaders expected the Tax Department to actually embrace that environment, but we did.

Our group ended up litigating an industry issue with the IRS, on whether stock option exercise deductions qualify for the R&E credit. We won in U.S. Tax Court, and that stands today. Then, we volunteered with the IRS in D.C. to request what is now known as an Advance Pricing Agreement. Apple obtained the first U.S. bi-lateral APA, with the Australian Taxation Office (ATO). The Tax Department went on to do a number of very innovative things, and I think everyone was very proud to work there.

I joined PwC to be part of their International Tax Services group in the early 1990's, focusing on Transfer Pricing consulting. My experience with Apple's audits and APAs gave me a good foundation for being a transfer pricing consultant. When I joined PwC (then C&L), the U.S. tax law was changing, requiring taxpayers to prepare their own self-audits and positions explaining their transfer pricing – the Section 6662(e) Contemporaneous Documentation requirements. So, the need for transfer pricing consultants exploded overnight, and it need continues to this day. The recent OECD BEPS initiatives mean that even more taxpayer documentation on transfer pricing is being required worldwide.

About 15 years ago I joined DLA Piper, where my consulting practice was focused on high technology companies, particularly those expanding overseas. With 40 offices worldwide, DLA Piper offers plenty of opportunities to be involved with international matters and other interesting legal things. For example, I volunteer for some pro bono legal matters, particularly setting up and advising tax-exempt charitable organizations.

What stands out as one or two of your most significant accomplishments in your career?

Well, obtaining the first U.S. bi-lateral APA for Apple was a game changer for several reasons. First, it was the first time the IRS granted a ruling on prospective transfer pricing, so it was an innovative procedure. I enjoyed playing a bit of "shuttle diplomacy" between the IRS and the ATO explaining Apple's operations and requested transfer pricing methods. But it was also a game changer for the type of transfer pricing we settled on, which allowed Apple to focus on an annual, bottom-line profitability target for Apple Australia, and make whatever intercompany COGS adjustments we needed to hit the agreed target. Previously, that wasn't allowed.

We could have kept that all secret because an APA is confidential. But we didn't. We spoke at TEI and other tax conferences about the process, the transfer pricing methodology, and the benefits, all of which helped propel the acceptance of the APA procedures and the CPM/TNMM method worldwide. Almost like changing the (tax) world.

How do you keep up to date with the changes in tax law and the ever-changing technology of the Silicon Valley tech companies?

Well, I teach a class at SJSU's MST Program called Tax Considerations for High Technology Companies. We focus on high tech issues such as R&D deductions, the R&E Credit, NOL's, withholding taxes, and international taxation. I just finished revising all my teaching materials to update them for the Tax Cuts and Jobs Act of December 2017. I have always enjoyed doing seminars and presentations. The best way to learn new provisions is to have to teach them, of course.

What do you think is one key area of our federal or state tax system that could/should be improved and why?

The recent TCJA radically changes the rules for how U.S. MNE’s are taxed on their foreign earnings. Coupled with the significant reduction in U.S. corporate tax rate from 35% to 21%, the new law has accomplished its intention of creating a significant incentive for U.S. companies to on-shore their operations in the U.S. So, that’s good.

But there is a sleeper provision in the TCJA that requires companies to capitalize their R&D expenditures, starting in 2022, in order to raise taxes. R&D has been immediately tax deductible since 1954. The change is crazy because the TCJA allows tangible assets, which clearly last years and years – to be written off immediately. It's like the U.S. wants factories but not Intellectual Property. So, I hope the High Tech industry can organize some lobbying efforts in the next several years to thwart the discriminatory R&D tax capitalization rules.

What do you think is the biggest challenge facing tax professionals today?

No doubt, keeping up with all the changes. Right now, international tax professionals are working hard to understand new rules like GILTI, FDII, BEAT, and FTC implications. Tax provisions are changing as a result, of course. And I don't know how SALT professionals do it - every state now seems to have rules for income and sales taxes that are different from every other state. Job security for tax professionals is the silver lining, I guess.

What advice do you have for students preparing for a career in tax?

The ideal situation is to have a good education in the fundamentals of taxation because the computational rules might change but one needs to the fundamentals to understand the policy "why" behind the law. But then, what's important is to do a good deal of computational work, finding the data, preparing tax returns, provisions, etc. Only when you have done the computational work do you know how it all really works. Then, you are in a position to give your executives or clients some advice on what to do.

If you could have dinner with anyone, who would it be?

Thomas Jefferson. He was a founder of our Country, having written the Declaration of Independence. He was Secretary of State under President Washington and later became the President. He personally was involved in incredible changes, including the Louisiana Purchase, the founding of the U.S. Navy, and the Lewis & Clark Expedition. I am sure he would have many tales to tell.

What is the most unusual item in your office or something in it that has special meaning to you?

My coffee mug with a TAX SJSU MST Program logo. It not only holds hot coffee, it reminds me to collect tax stuff for my next class.

Picture of Mr. Eric Ryan with Student Editor Sara (Yaqin) Sun