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

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# Summaries for the 33<sup>rd</sup> Annual TEI-SJSU High Tech Tax Institute

**Held on November 13<sup>th</sup> and 14<sup>th</sup>, 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<sup>1</sup>, the date of the change could be prior to the end of the 4<sup>th</sup> quarter in 2017. If the signature happens before December 31<sup>st</sup>, 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

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<sup>1</sup> U.S. 115<sup>th</sup> 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](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.<sup>2</sup> 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

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<sup>2</sup> Jim Tankersley, Alan Rappoport, 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 4<sup>th</sup> 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<sup>1</sup>, 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.<sup>2</sup> Businesses should assess the potential impact and recommend changes to their supply chain structure.

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<sup>1</sup> 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>

<sup>2</sup> 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](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.<sup>3</sup> States hoped that *Quill* would be

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<sup>3</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)

overturned by the Court soon.<sup>4</sup> 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).<sup>5</sup>

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.<sup>6</sup>

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.<sup>7</sup> Income from the foreign branch is treated as income from the wholly-owned subsidiary. Thus, it will be

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<sup>4</sup> *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.

<sup>5</sup> 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](https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF) (Internal Revenue Service)

<sup>6</sup> Reg. §1.954-3

<sup>7</sup> 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 33<sup>rd</sup> 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.”<sup>1</sup>
- 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

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<sup>1</sup> 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.<sup>1</sup>

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 33<sup>rd</sup> 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<sup>1</sup> 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<sup>2</sup> and the regulations<sup>3</sup> thereunder, as follows:

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<sup>1</sup> Chief Counsel Ruling 2017-01. Retrieved from: <https://www.ftb.ca.gov/law/ccr/2017/01.pdf>

<sup>2</sup> See Cal. Rev. & Tax. Code § 25136(a)(1)

<sup>3</sup> 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)<sup>4</sup> 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.

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<sup>4</sup> 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.*<sup>5</sup>

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<sup>6</sup> and the Commerce Clause.<sup>7</sup> 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*<sup>8</sup>

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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<sup>5</sup> 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>

<sup>6</sup> *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:

<sup>7</sup> *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.

<sup>8</sup> *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<sup>9</sup> – 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.

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<sup>9</sup> 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.<sup>10</sup> However, Mr. Brady foresees an issue that if a company acquires a corporation with worthless stock would the value of the stock be disregarded?<sup>11</sup>
- 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*<sup>12</sup>, 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

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<sup>10</sup> IRC §332

<sup>11</sup> IRC §368(a)(1)(C)

<sup>12</sup> *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)<sup>1</sup>

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<sup>1</sup> 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](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.<sup>2</sup>

### 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

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<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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

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<sup>3</sup> 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](https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en)

<sup>4</sup> 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.<sup>5</sup> 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:

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<sup>5</sup> 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.”<sup>6</sup>
- 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).<sup>7</sup>

## 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.

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<sup>6</sup> IRS Section 367 (d)(2)(A)

<sup>7</sup> 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>