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Summaries from the 2019 35th Annual TEI-SJSU High Tech Tax Institute

Hanna Shatanionak CPA
San Jose State University

Liubov (Luba) Shilkova
San Jose State University

Xiaoyue (Tina) Tan
San Jose State University

"Still Keeping to the BEAT"

By: Hanna Shatanionak, CPA, MST student

The 35th Annual TEI-SJSU High Tech Tax Institute took place on November 4 to 5, 2019 in Palo Alto, CA. This conference featured panels with representatives from government, industry, and academia. The speakers discussed the latest U.S. and international tax developments and issues. The panel, "Still Keeping to the BEAT" addressed the issues related to the interpretation of the new Tax Cuts and Jobs Act (TCJA) guidance, new planning considerations, and cautions to exercise for tax success. From the government, the panel was represented by Elena Virgadamo, Senior Advisor, Assistant Deputy Commissioner, International, IRS, and Peter Merkel, Branch Chief, Office of the Associate Chief Counsel (Int'l) Branch 5, IRS. The tax practitioners on the panel were Taylor Reid, Partner at Baker & McKenzie, Gabe Gartner, Principal, National Tax Services - Mergers & Acquisitions at PwC, and David Forst, Partner and Tax Group Chair at Fenwick & West LLP. The IRS representatives shared with the audience the work progress on the new regulations in order to provide guidance on the new rules. The tax advisors shared their client service experience with the BEAT implementation and suggested solutions that tax practitioners should consider for the different types of businesses and entity structures.

The panel started with an overview of the key BEAT concepts and then discussed the proposed BEAT regulations and presented structure examples for outbound and inbound context that highlighted some of the issues with the BEAT. At the time of the presentation only the proposed regulations were available; the final regulations were under review. On December 21, 2018, the Treasury Department and the IRS published proposed regulations (REG-104259-18) under section 59A, and proposed amendments to 26 CFR part 1 under sections 383, 1502, 6038A, and 6655 in the Federal Register (83 FR 65956). On December 6, 2019, the Treasury Department and the IRS published final regulations under sections 59A, 383, 1502, 6038A, and 6655.[1]

Code Section 59A imposes the base erosion and anti-abuse tax (BEAT) as an excess of 10% (5% for 2018, 12.5% after 2025) of the modified taxable income over the regular tax liability net of allowable credits. The modified taxable income is the regular taxable income before any benefits or deductions related to base erosion payments made by the applicable taxpayer. The panel discussed five key BEAT concepts during the overview section of the presentation:

- Applicable taxpayers
- Base erosion percentage
- Base erosion tax benefit
- Base erosion payment

[1] TD 9885 (12/12/19), Tax on base erosion payments of taxpayers with substantial gross receipts., IRC Sec. 59A.

- Base erosion minimum tax

Applicable Taxpayer and Base Erosion Percentage

Gabe Gartner introduced "applicable taxpayers" and "base erosion percentage" concepts. In general, taxpayers must meet three requirements when ascertaining whether they are subject to the BEAT. First, applicable taxpayers must be U.S. corporations other than regulated investment companies (RICs), real estate investment trusts (REITs), or S corporations. Foreign corporations with an effectively connected income can be subject to the BEAT. Second, average annual gross receipts of applicable taxpayers must be at least $500 million in the preceding three taxable years. Third, a base erosion percentage, which represents the fraction of base erosion tax benefits over total applicable deductions and other benefits net of exclusions, must be 3% or higher. Mr. Gartner noted that taxpayers usually experience an issue with the 3% threshold requirement. The calculation is complicated and time-consuming. The challenge is to manage the base erosion percentage below the threshold on an annual basis. Only a small number of corporations have the base erosion percentage on a border line, when it's close to the 3% threshold. The majority of large corporations have a lower base erosion percentage than the threshold. For companies with the base erosion percentage much higher than the threshold, Mr. Gartner suggested to look at other sections to see if qualified exclusions may apply.

Base Erosion Tax Benefit

Taylor Reid continued the overview of the BEAT and introduced the next key concept, a base erosion tax benefit. This is a deduction allowed for an amount paid or accrued by a corporation to a foreign person that is a related party. Elena Virgadamo highlighted the importance of the related party element and mentioned that the IRS will be looking closely into whether the scope of the foreign related party was properly determined. Mr. Reid also noted that the applicable taxpayer aggregation rule can trigger the BEAT. For example, when two U.S. consolidated groups with annual gross receipts less than $500 million on a separate basis have a common foreign ownership, they must combine their annual gross receipts for the $500 million test. As a result, they can find themselves in the BEAT.

Base Erosion Payments

Mr. Reid described four categories of base erosion payment transactions. A base erosion payment is an amount paid or accrued by a taxpayer to a foreign related party. It includes any type of payment that can generate base erosion tax benefits, including a deductible payment and a payment to acquire depreciable or amortizable property. Another two base erosion payment transactions are consideration for reinsurance and a payment to surrogate foreign corporations (SFCs) or to a related foreign person that reduces the gross receipts of the taxpayer. Per the special rule, a foreign related party concept applies only to the corporation that first became a surrogate foreign corporation after November 9, 2017. Mr. Reid mentioned an interpretation issues related to the BEAT. Base erosion payments are payments to a foreign related party for which a deduction is allowable, but base erosion tax benefit is a deduction that is allowed. The taxpayer may consider opting out of the deduction to solve the 3% threshold issue.

Mr. Reid and Mr. Forst also discussed the issue related to property acquisition that can be overlooked by a taxpayer. The taxpayer is taking a deduction in the form of depreciation or amortization with respect to a property that was acquired through a payment to a foreign related person. For the purpose of calculation base erosion tax benefits, the taxpayer must include not only the step up portion, but the entire amount of depreciation related to the property. The same applies to an IP acquisition when amortization can create a BEAT issue.

Base Erosion Payment Exceptions

Mr. Forst discussed base erosion payment exceptions and related issues. Payments that reduce gross income, including COGS, are not considered as base erosion payments (except to a SFC). Mr. Forst suggested, that increase of COGS in the structure can be a helpful strategy to reduce BEAT exposure. Another exception is a payment at cost for low-margin services, when it is qualified for the services cost method. Only a mark-up is a base erosion payment, but cost portion is an exception. Two other exceptions are payments for qualified derivative contracts and payments subject to withholding tax at full statutory rate.

Base Erosion Minimum Tax

1. The BEAT tax equals the excess of modified taxable income at the BEAT tax rate, over regular tax liability, reduced (but not below zero) by an excess of credits allowed over the sum of R&D credits and limited §38 credits.

2. Modified taxable income equals regular taxable income without regard to (1) any base erosion tax benefits and (2) a base erosion percentage of net operating loss deduction under §172.

Mr. Reid highlighted that usually the gap between modified and regular taxable income is large enough to turn off the BEAT, as it takes a lot of deductions to trigger base erosion minimum tax. At the same time he highlighted three significant risk factors that taxpayers must consider. The first factor is the dicey combination of a large amount of add back deductions and a thin taxable income. Mr. Forst also noted that a company with a low margin has a higher chance to have the BEAT than a profitable company. A lower regular taxable income increases the risk for the BEAT due to lower regular tax liability. The economic slowdown can also increase the chance for the BEAT due to the decrease in the company's profitability. The second factor is a significant amount of credits that sheltering an income from regular income tax liability. The third factor is a large NOL carryforward that leads to a very low tax liability. In such cases 3% threshold for base erosion percentage becomes a significantly important indicator.

In the conclusion of the overview Mr. Forst emphasized that the BEAT liability may arise in any year, even if taxpayers were not subject to the BEAT in the past. The speakers stated several times that monitoring the BEAT must be an ongoing annual process for affected taxpayers. The BEAT is a complicated issue. It requires detailed calculation and constant examination of potential risk factors during tax planning. It will be helpful for taxpayers to include the BEAT model calculation as part of the quarterly tax provision routine, even if the bottom-line result is zero at that time. This will help to stay on top of any changes and will protect from an unexpected tax liability. As emphasized by the panelists, “even a small amount of base erosion tax benefits can throw the taxpayer into the BEAT”.

Transfer Pricing

By: Xiaoyue (Tina) Tan, MST student

Transfer pricing issues have become more complicated for multinational corporations from a tax compliance perspective in the digital economy. Facebook, Amazon, Coca-Cola, and other multinationals have litigation because of transfer-pricing disputes. However, the impact of transfer pricing could also apply to any company which is looking to expand overseas. A panel of seven experts from the international tax field presented at the High Tech Tax Institute held on November 4 and 5, 2019 in Palo Alto. The panelists were Sharon Heck from Intel Corp, Daniela Ielceanu from PwC, Eli Hoory from the IRS, John Hinman from the IRS, Margaret Critzer from Alvarez & Marsal Tax and LLC, Matt Kramer from Grant Thornton, and Vasudha Rangaprasad from Deloitte.

The panel analyzed development, enhancement, maintenance, protection, and exploitation (DEMPE) of intangibles, the functional cost diagnostic (FCD) model, and digital taxes with proposed profit-allocation.

What is Transfer Pricing?

A transfer price is the price charged between related parties in an intercompany transaction. Transfer-pricing policies can directly affect a company's after-tax income to the extent that tax rates differ among countries.

Section 482 gives the IRS authority to adjust taxable income between two related parties to accurately reflect the income earned by each party.[1] As detailed in Regs. Sec. 1.482-1(b), the transfer prices between related parties must meet the arm's-length standard that the income from related taxpayers is consistent with the income from unrelated taxpayers in a comparable transaction under comparable circumstances.[2] Not only does this standard apply to the transfer of tangible goods, but also to intangibles. Determining a company's transfer prices requires identifying where value is created in an organization and transferred across group members. Typically, value can be characterized and the comparability of a transaction with one between unrelated parties can be determined by factors including the assets used, the risks assumed, and the functions performed by each group member in an intercompany transaction.

Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE)

DEMPE is designed to analyze important functions, assets used, risk assumption and control related to the intangibles within multinational corporations in the development, enhancement, maintenance, protection and exploitation of intangibles. Ms. Ielceanu emphasized that DEMPE is necessary, but it is not sufficient in the digital economy. She referred to Director of OECD, Pascal Saint-Amans's words, "DEMPE is nice, [..] it may be killing zero tax jurisdictions, cash boxes, and so, but does not do much of a job." She thought that DEMPE is all about exercising

[1] IRC Sec. 482, Allocation of income and deductions among taxpayers
[2] Regs. Sec. 1.482-1(b)

control and assuming and managing risk. She pointed out the important functions from the OECD Guidelines for any intangibles, such as "design and control of research and marketing programmes, control over strategic decision regarding intangible development programmes, and ongoing quality control over delegated functions that may have a material effect on the value of intangible."

Ms. Ielceanu explained six steps of DEMPE analysis to show how it requires functional and risk analysis. Step 1 to step 3 are analysis of facts and circumstances, step 4 to step 5 are analysis of deviation, and step 6 is potential adjustment. Step 3 is one of the most critical steps is functional analysis. In step 3, the conduct of each party needs to be analyzed. Taxpayers need to figure out the party who performs functions, uses assets, and manages risks related to DEMPE of IP, and the party who performs control over economically significant risks.

On October 9, 2019, the OECD issued the Unified Approach to attempt to fit in the digital economy. The proposal outlines new methods for allocating taxable profit. There are three separate categories of taxable profits that could be used to provide new taxing authority or create a baseline for taxing certain activities:

Amount A: formulaic allocation of a portion of global profit above a baseline, based on location of sales.

Amount B: fixed return for some routine activities (marketing and distribution).

Amount C: additional return for functions exceeding baseline determination under Amount B in line with existing TP rules (+ dispute resolution with respect to Amount A).

Ms. Ielceanu emphasized that DEMPE analysis still matters with these reallocations. The complexity behind the proposal will create a host of new issues that will impact companies' decisions in the digital economy.

APMA's Functional Cost Diagnostic Workbook

On February 26, 2019, the IRS Advance Pricing and Mutual Agreement (APMA) program issued a Functional Cost Diagnostic model. The Functional Cost Diagnostic model (the 'FCD') requires the taxpayer to provide financial information for cases where the taxpayer's proposed covered transactions, in light of the taxpayer's business operations, suggest that "material non-benchmarkable contributions" are being made by two or more related parties. Ms. Critzer explained that the model is a tool for taxpayers to use in certain Advance Pricing Agreement (APA) situations to identify, organize, and analyze certain cost assumptions with U.S. and non-U.S. entities. The workbook helps taxpayers walk through APAs situation step by step:

- Identify, organize, and analyze "functional" costs,
- Analyze the economic contributions associated with functional costs,

• Identify functional costs associated to "routine" functions and that the economic value of such contributions is measurable by reference to third- party benchmarks,

• Identify functional costs that may have an economic value but are not benchmarkable and last beyond a single accounting period.

Ms. Critzer mentioned that the workbook will be requested on a case-by-case basis. There is no blanket requirement for all the APA requests. The FCD has a "pro-forma" profit split built into it, but APMA's view on whether the profit split method is the "most appropriate" method in the taxpayer's case will be based upon a full analysis of the taxpayer's request in light of the OECD Guidelines. IRS has stated publicly that the model will be change in next two years. The workbook may be requested by APMA in either "inbound" (foreign-parent) or "outbound" (U.S.-parent) cases. Taxpayers need to take careful consideration of the costs incurred, documentation of intercompany transactions, and re-evaluating the transfer pricing policy.

Digital Taxation

Mr. Kramer noted that digital taxes are intended to address a potential mismatch between where profits are taxed under traditional tax principles and how and where digital activities create value. Certain elements are unique to digital business models. First, highly digitalized businesses can be heavily involved in the economic life of a jurisdiction without any, or any significant, physical presence. Second, such businesses are also highly reliant on intellectual property, which is mobile. Third, a high level of value comes from data, user participation, network effects, and the provision of user-generated content. In the absence of a global consensus, many countries have unilaterally implemented taxes that target the digital economy.

Mr. Kramer highlighted that the current unified approach raises lots of questions. The OECD concedes that the allocation rules "go beyond" the arm's length principle and depart from the separate entity approach. The arm's length principle is becoming an increasing source of complexity. Simplification is desirable to contain increasing administration and compliance costs of trying to apply it. However, the unified approach needs to address several issues that deviate from the arm's length principle, such as where profits will come from, and potential double taxation attributable to fixed returns. Mr. Kramer posited that the formulaic approach will require significant inter-governmental coordination to achieve global consensus and avoid double taxation. Existing treaties relieving double taxation apply to MNEs on an individual entity and individual-country basis. Differences in formulas between countries could create additional disputes involving multiple countries. New arbitration procedures could be necessary. Also, it is possible that the approaches set out in Pillar 1 do not remain confined to digital service transactions.

In conclusion, the speakers highlighted increased compliance burden given the additional complexity of the new formulaic Amount A and its interaction with Amounts B and C. If not uniformly applied, it could lead to additional disputes and double taxation risks. The Unified Approach is far from simple. Therefore, companies will want to analyze the potential impact on their business models and engage with the work of the OECD and policymakers at both national and multilateral levels as to the business implications of these proposals.

U.S. International Tax Issues and Developments Summary

By: Liubov (Luba) Shilkova, MST Student

The 35th TEI-SJSU High Tech Tax Institute began with U.S. International Tax Issues and Developments, presented by Jim Fuller, Partner at Fenwick & West LLP. The presentation was engaging and covered a tremendous number of important developments in international taxation.

This summary covers some of the points made regarding Prop. Reg. 1.1446(f) relating to the Tax Cuts and Jobs Act (TCJA) of 2017. They deal with withholding tax in the case of disposition of an interest in a partnership engaged in a U.S. trade or business.

Exceptions to withholding

Mr. Fuller briefly discussed exceptions to withholding that are included in the proposed regulations. There are six exceptions under Prop. Reg. 1.1446(f)-2(b) that allow a transferee to discharge its obligation to withhold tax under Section 1446(f)(1). In general, these exceptions deal with certain reliable and correct certifications or books that were received from the transferor's side.

a) <u>Certification of non-foreign status by transferor</u>

Prop. Reg. 1.1446(f)- 2(b)(2) clarifies specific requirements to be considered for the certification of non-foreign status. Also, it provides that a valid Form W-9, Request for Taxpayer Identification Number and Certification, meets the requirements for this purpose under the proposed regulation, including the Form W-9 for the transferor that is already in the transferee's possession.

b) <u>No realized gain by transferor</u>

In general, this exception states that if the transferor can provide a certificate stating that no gain (including Section 751 ordinary income) was realized during the transfer of the partnership interest, the transferee (other than a partnership's distributions) may rely on this certification. A similar rule applies to partnership distributions. According to the Prop. Reg. 1.1446(f)-2(b)(3)(ii), in order to determine whether there is a realized gain or not as a result of the transaction, a partnership is allowed to rely on its books and records or on a certification provided by the transferor.

c) <u>Less than 10 percent effectively connected gain</u>

In general, no withholding is required in the case of receiving the certification by the transferee from the transferor. This certification must clarify that the amount of net effectively connected gain resulting from the deemed sale of all of the partnership's assets at fair market value as of the determination date would be less than 10% of the total net gain or there is no gain. This reduces the threshold from 25% to 10%.

The same rule applies to partnerships that are transferees because they make a distribution. Under Prop. Reg. 1.1446(f)-2(b)(4)(ii) they are permitted to rely on its books and records stating the same requirements as apply for the certification.

d) Certification on effectively connected taxable income (ECTI)

In general, no withholding is required in the case of receiving certification by the transferee (other than a partnership that is a transferee by reason of making a distribution) from a transferor disclosing the following facts:

- the transferor has been a partner for at least three years
- its share of ECI for each of those years was less than 10% of its total distributive share and less than $1,000,000
- transferor must have filed income tax returns and paid taxes for all three years in the test.

Also, this exception states that the foreign transferor is required to receive Form 8805 from the partnership in each of the years it was a partner, unless its share of ECI in that year was zero due to ECI loss or deductions.[1]

The proposed regulations state that in the absence of net distributive transferor's share of income allocated to any testable year, this transferor is not allowed to provide the certification for purposes of this exception.

The same rules apply for a distributing partnership. If this partnership is a transferee, it can rely on its books and records to meet the requirements described above.

e) Certification of nonrecognition by transferor

The transferor can provide a certificate stating that the transfer under consideration is subject to a nonrecognition provision of the Code. Prop. Reg. 1.1446(f)-2(b)(6) provides requirements for such certification. It must include the transfer description and the relevant laws and facts that deal with the nonrecognition provision.

There can be a withholding adjustment if only a portion of the gain realized on the transfer is related to a nonrecognition provision.

f) Treaty exemption

The transferor can provide a certificate that states that it is exempt from taxes by reason of an income tax treaty. This exception provides that the certification must include a valid Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and

[1] Prop. Reg. 1.1446(f)-2(b)(5)(iii).

Reporting (Individuals), or W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities) containing the information necessary to support the claim for treaty benefits.[2] Also, it is a transferee's obligation to send a copy of the certification to the IRS by the 30th day after the date of the transfer.

Under Prop. Reg. 1.1446(f)- 2(b)(7)(i) this certification does not apply for situations when treaty benefits are subject to only a portion of the gain from the transfer.

Liability of agents is one of the most interesting new rules under proposed Prop. Reg. 1.1446(f)-5(b). This liability is imposed if an agent of a transferor or transferee is aware that the certification given to the transferor is false. In this case, under proposed regulations, an agent 's obligation is to notify the transferee (or other person required to withhold) about this fact. As a result, in a case of receiving such notice, the certification is unreliable for applying for withholding exemptions or determining the withhold amount. Also, as a part of procedural requirements, an agent must send a copy of such notice with a cover letter to the IRS. In a case of not providing this notice, there is an agent's liability for the tax that the person (that should have received the notice) would have been required to withhold under Section 1446(f). However, under Prop. Reg. 1.1446(f)-5(b)(4), the compensation amount that the agent derives from the transaction limits the agent's liability. In addition, civil and criminal penalties may apply to an agent who fails to disclose false certification.

Mr. Fuller also talked briefly about brokers for purposes of this Regulation. They are not considered as agents if they are required to withhold under Prop. Reg. 1.1446(f)-4.

At the end of his presentation, Mr. Fuller noted that some of the proposed regulations met much criticism. Overall, this presentation identified key U.S. international tax updates. It is important for tax practitioners to be aware of proposed regulations and international rules to provide clients with professional advice and help them build appropriate tax strategies.

[2] Prop. Reg. 1.1446(f)- 2(b)(7)(i).