WASHINGTON TAX NEWS

Potomac Law Tax Newsletter—September 2016 **Susan Rogers**

The **Presidential and Congressional campaigns** are in full gear, while Congress has returned to Washington with a target adjournment date of October 7th to prepare for the November 8th elections. In an election year that has been unconventional, there is considerable uncertainty about what the political landscape in Washington will be post-election, not only with respect to the Presidential election but also control of the Senate and the political makeup of the House.

The highest priority of Congress during this short legislative session is to address the **appropriations bills needed to fund FY 2017** starting on October 1st. Since the House has passed only five spending bills and the Senate only three spending bills, a **Continuing Resolution** (CR) must be considered – with an open question about whether the CR will extend into 2017 or terminate prior to the end of 2016 for consideration in a lame duck session.

Other issues that will likely be considered prior to the end of the year include Zika funding and a floor vote on impeachment of IRS Commissioner Koskinen. Progress on **comprehensive tax reform** is unlikely with most of the focus in Washington in the area of tax policy centered on guidance from the Treasury and IRS and the ongoing discussion in Congress of the potential impact of the proposed Code section 385 regulations. Other open issues include energy legislation, defense authorization, gun control, criminal justice overhaul, the Trans Pacific Partnership and the Water Resources Development Act.

For more information on these issues, please contact Susan Rogers at srogers@potomaclaw.com or 202.492.3593.

Congress has returned to Washington for a brief pre-election legislative session with a challenge to resolve the issue of funding the Federal Government for the new fiscal year beginning on October 1st.

Susan Rogers

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International Issues

EU State Aid Investigations/Apple

The European Union (EU) issued a decision that **Apple Inc.** must pay 13 billion euros ($14.5 billion) plus interest as a result of a deal between the company and the Irish government that allowed Apple to underpay its Irish taxes between 2003 and 2014 in return for 5500 company jobs. Apple's effective tax rate ranged from 1 percent in 2003 to 0.005 percent in 2014. Both Apple and Ireland – to whom the taxes would be paid – have stated that they will fight the decision in EU courts. This decision is part of the ongoing EU probe in state-aid cases, which has drawn opposition from the US Treasury based on a belief that US companies have been targeted in the investigations.

There has also been opposition from Congress to the state **aid investigations by the EU** and this latest action against Apple. Despite suggestions that Congress should respond, these may be issues that can only be addressed as part of tax reform especially in light of the abbreviated legislative schedule for the remainder of 2016. One open issue is whether all of the additional taxes paid by Apple and other targeted corporations will be fully creditable against US taxes, since Treasury has not yet confirmed the treatment.

OECD/BEPS

The OECD released a **Discussion Draft** covering **approaches to address base erosion and profit shifting (BEPS) involving interest in the banking and insurance sectors** under Action 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments) of the BEPS Action Plan. The report on Action 4, which was released in October 2015, established a common approach to tackling interest deductions, but highlighted a number of factors which suggested that a different approach may be needed to address risks posed by entities in the banking and insurance sectors. The Discussion Draft focuses on (1) the risks posed by banking and insurance groups to be addressed under Action 4; (2) approaches to address risks posed by banks and insurance companies; and (3) approaches to address risks posed by entities in a group with a bank or insurance company. Comments were required by September 8, 2016.

Miscellaneous Issues

House Judiciary Chairman Goodlatte (R-VA) has released a new **online sales tax draft bill** which proposes a system using the tax base of an online retailer's state, a tax rate set by the buyer's state, and collection by the seller's state. This bill varies from his previous draft legislation which set up a system where retailers would have charged sales tax based on their own state and local rates. It is unlikely that this issue can be resolved prior to the end of the year.

The **Joint Committee on Taxation (JCT) issued its annual report** describing the revenue proposals in the President's FY 2017 Budget. Earlier this year, the JCT issued its summary of revenue estimates on these tax proposals. The report includes four sections covering: (1) new revenue proposals; (2) revenue proposals that have been substantially modified from prior budgets; (3) modified proposals resulting from legislation enacted in 2015; and (4) a summary of proposals that were included in prior year budgets.

The Financial Accounting Standards Board **(FASB)** issued a **proposed Accounting Standards Update (ASU) to enhance disclosure requirements on income taxes**. The proposed ASU would modify existing disclosure requirements and provide additional disclosure requirements for income taxes. The modifications and additions include describing an enacted change in tax law, disaggregating certain income tax information between foreign and domestic operations, and explaining the circumstances that caused a change in assertion about the indefinite reinvestment of undistributed foreign earnings.

Political Campaigns—Tax Issues

Democratic Presidential nominee Hillary Clinton has targeted corporate outsourcing as a focus of her campaign with plans to use revenue raised from targeted tax increases to offset the cost of several other policy proposals including education and infrastructure programs. She also released a new platform for small business that includes a standard deduction for smaller companies, similar to that allowed to individuals.

Republican Presidential nominee Donald Trump issued a revised tax reform plan that included cutting the top income tax rate to 33 percent (rather than 25 percent). He and his advisors have continued to focus on his tax plan to benefit pass-through business with a top rate of 15 percent. They stated that rules will be included to ensure that the wealthy do not benefit from the rules, especially by circumventing them to characterize wage and salary income as business income. Trump has called for ending the preferential treatment of carried interest, but the proposed 15 percent business rate would likely lower the taxes of investment fund partners.

The Obama Administration's proposed Section 385 debt-equity regulations targeting earnings stripping continue to receive considerable attention and opposition from Congress and the business community. Treasury Secretary Lew has met again with Congressional tax writers, and Treasury has suggested that changes to the proposed rules will be made. The business community and Republican leadership, however, are asking that the rules be redone which could delay their finalization.

Senate Finance Committee Chairman Hatch (R-UT) wrote to Treasury Secretary Lew discussing the "grave concerns" he has with the proposed Code section 385 regulations. Chairman Hatch stated in his letter to Treasury that he is "concerned that the Treasury Department is moving at an unprecedented pace," and that he is concerned that Treasury is "acting contrary to statutory and Executive Order requirements" including the Congressional Review Act.

Chairman Hatch has requested that Treasury re-propose the rules to ensure that should Treasury issue regulations under Code section 385, "the Department does so in a thoughtful, prudent, and legal manner."

Treasury Regulations on Section 385

Several members of the Ways & Means Committee including Chairman Brady (R-TX) sent a letter to Treasury that "continues the discussion" which began with a June 28th letter, citing the broad scope of the rules, and a July 6th meeting with Treasury to "highlight the ways the regulations as proposed would prevent American businesses from conducting basic, day-to-day operations and transactions." The letter states that during the July 6th meeting, the Treasury Tax Policy team acknowledged several unintended consequences of the proposed regulations that will be corrected before they are finalized including the areas of cash pooling arrangements and the impact on S corporations and REITs. The letter also notes that there are multiple areas of concern that Treasury did not adequately address in the meeting including covering foreign-to-foreign transactions and the effect on transactions involving partnerships and disregarded entities.

The US Chamber of Commerce and the Texas Association of Business filed suit against the IRS and Treasury in the US District Court for the Western District of Texas with respect to the regulations issued April 4th targeting inversions. The suit alleges that the "multiple domestic entity acquisition rule" included in the regulations harms members of the plaintiffs, citing the abandoned proposed merger between Pfizer Inc. and Allergan Plc. The suit argues that the regulations violate the Administrative Procedure Act and constitute "arbitrary and capricious rulemaking" and that Treasury did not provide sufficient notice and opportunity for comment with respect to the regulations.

The IRS has revised a chief counsel notice (CC-2016-009) from June 30, 2016, stating that any case in exam or litigation raising an issue under Code section 385 requires review by an Associate Office (and therefore National Office review) or the Special Counsel to the National Taxpayer Advocate. The updated requirements also expand the review requirement to issues involving Code section 385(a) and (b) in addition to 385(c) covered under prior requirements.

Treasury/IRS 2016-2017 Priority Guidance Plan

Treasury and the IRS issued their 2016-1017 Priority Guidance Plan, which includes 281 projects that the IRS expects to work on for the next year.

The plan includes several continuing projects affecting **corporations and shareholders**, including the finalization of proposed regulations under Code section 385 on earnings stripping and related party debt. Other projects cover: (1) regulations under section 302 and related provisions regarding unrecovered basis in shares of stock that are actually or treated as redeemed; (2) final regulations under sections 305(c) and 1441 regarding the amount and timing of, and the withholding obligations on, deemed distributions from conversion ratio adjustments on convertible debt and stock; (3) regulations under section 336(e) to revise the treatment of certain stock dispositions as asset sales; (4) final regulations under section 337(d) regarding certain transfers of C corporation property to real estate investment trusts and regulated investment companies; and (5) several projects under section 355.

The plan includes a number of projects in the **partnership tax** area including: (1) final regulations under Code section 1.337(d)-3 relating to partnership transactions involving a corporate partner's stock or other equity interests; (2) final regulations under section 469 (h)(2) concerning limited partners and material participation; (3) final regulations under section 732(f) regarding aggregation of basis for partnership distributions involving equity interests of a partner; (4) final regulations under sections 704, 707 and 721 on management fee waivers; (5) final regulations under sections 704, 734, 743, and 755 relating to the disallowance of certain partnership loss transfers and no reduction of basis in stock held by a partnership in a corporate partner; (6) regulations under section 707 relating to disguised sales of property and regulations under section 752 regarding a partner's share of liabilities; (7) final regulations under section 752 regarding related person rules; and (8) final regulations under section 7704(d)(1)(E) regarding qualifying income for publicly traded partnerships.

Treasury/IRS 2016-2017 Priority Guidance Plan (cont.)

The plan includes nearly 40 projects in the area of **international tax** rules covering Subpart F, inbound and outbound transactions, foreign tax credits, transfer pricing, sourcing and expense allocation, and treaties. Two new international projects are included described as: (1) Regulations under Code section 1256(g)(2) regarding the definition of a foreign currency contract; and (2) Guidance regarding the procedures for US persons that are ultimate parent entities of multinational enterprise groups to voluntarily report certain information on a tax-jurisdiction-by-tax-jurisdiction basis (related to country-by-country regulations issued earlier this year).

Audit Regime Election Rules for Partnerships

The IRS issued temporary and proposed regulations that instruct partnerships on the time, form and manner for electing to be subject to the **new audit regime** enacted in the 2015 Bipartisan Budget Act (BBA). The new regime is applicable to partnerships with returns filed for tax years beginning after November 2, 2015 and before January 1, 2018. In Notice 2016-23, the IRS outlined additional partnership audit guidance that it expects to issue in the near future.

Under the rules, a partnership that elects to apply the new partnership audit regime to a partnership return filed for an eligible taxable year may not elect out of the new rules under the small partnership exception under Code section 6221(b) as added by the BBA with respect to that return. Once made, the election can only be revoked with the consent of the IRS. The rules do not permit early opt-in elections unless and until either an actual examination of a relevant partnership tax year (e.g. 2016 or 2017) starts or a refund request is filed for such a year in 2018 or thereafter.

Other Issues

The IRS released **final regulations relating to property transferred in connection with the performance of services** with no changes to the proposed regulations issued in July of 2015. The final regulations affect certain taxpayers who receive property transferred in connection with the performance of services and make an election to include the value of substantially non-vested property in income in the year of transfer. They also remove the requirement in the existing regulations that a taxpayer submit a copy of a section 83(b) election with the taxpayer's tax return for the year in which the property subject to the election was transferred.

The IRS issued **proposed regulations** under Code section 2704 to prevent the **undervaluation of interests in corporations and partnerships when calculating estate, gift, and generation-skipping transfer taxes**. The proposed regulations focus on certain lapsing rights and restrictions on liquidation in the valuation of transferred interests including: (1) what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership; (2) deathbed transfers that result in the lapse of a liquidation right and clarification of the treatment of a transfer that results in the creation of an assignee interest; (3) changes to the definition of "applicable restriction" with respect to a comparison to the liquidation limitations of state law; and (4) new rules to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not members of the family.

For additional information and advice on these issues, please contact:

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Susan Rogers has 30 years of experience in the tax policy field in Washington including several years as Majority Tax Counsel to the House Ways & Means Committee and extensive experience managing global tax issues for a Fortune 100 multinational. Ms. Rogers' practice focuses on providing information and strategic advice to clients on US and international tax policy issues and advice on how to manage tax policy risks.