WASHINGTON TAX NEWS

Potomac LAW GROUP PLLC

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

The House and Senate have completed their September legislative session and will now be in an **extended recess until after the November 8th elections**. On September 28th, Congress approved and sent to President Obama a **continuing resolution to fund the federal government** from the beginning of the new fiscal year on October 1st through December 9th. In light of the fact that Congress will have to act on additional legislation to fund the government beyond that date in a lame duck session, there is a possibility that issues such as tax extenders and technical corrections could be included in such legislation.

Congress is expected to return to work on November 14th, take a one-week break for Thanksgiving, and complete their work for 2016 by December 16th.

The Treasury Department issued **final debt-equity regulations under Code section 385 to address "earnings stripping,"** which is a method by which a US company borrows money from a foreign affiliate, thereby shifting income from the US to a foreign jurisdiction with lower tax rates — arguably eroding the US tax base. These regulations had garnered significant comment and criticism since the issuance of proposed regulations earlier this year, and the final regulations, which are significantly narrower in scope, reflect changes that appear to respond to comments received by the Government from taxpayers. A major revision in the final 518-page rule eliminates the "bifurcation rule," which would have given the IRS broad discretion to treat certain interests in a corporation as debt in part and stock in part. The Treasury Department and the IRS will continue to study this issue according to the new rules.

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Before leaving town for an extended recess ending after the November 8th elections, Congress approved a short-term funding bill for the federal government. The same issues must be addressed in a lame duck session in December but with uncertainty as to how they will be resolved pending the outcome of the elections.

Susan Rogers

In This Issue

Congressional Update—Tax Issues

Extenders/energy provisions: Leadership in both the Senate and House have suggested that they will consider **renewal of several alternative energy provisions** that will expire at the end of 2016, but there is no certainty of action, and it may depend on the outcome of the elections. There are also a number of other provisions that will expire at the end of 2016 including breaks for mortgage forgiveness, energy-efficient homes, racehorse owners, and film productions.

House/Ways and Means Committee: Prior to recessing, the House Ways & Means Committee approved several **targeted tax bills** covering nuclear production tax credits, student loan debt issues, tax-exempt water cooperative rules, stock options for start-up businesses, and tax relief for citrus groves hit by a bacterial infection. House leadership has indicated that they will schedule these bills for House Floor action during the lame duck session. The House approved legislation that would reduce the threshold for claiming the itemized deduction for medical expenses to 7.5 percent of adjusted gross income (AGI) for all taxpayers, reversing a provision in the Patient Protection and Affordable Care Act of 2010 that increased the threshold for claiming the deduction to 10 percent of AGI. The Senate is not expected to consider this bill, which would likely be vetoed by President Obama.

Senate/Senate Finance Committee: The Senate Finance Committee voted unanimously to approve legislation aimed at **expanding access to retirement account savings and simplifying plan administration for small businesses and multiemployer plans**. The Retirement Enhancement and Savings Act of 2016 includes provisions recommended last year by the bipartisan SFC working group on savings and investment as well as certain provisions included in the discussion draft of retirement account reform legislation released by ranking Democrat Wyden (D-OR) in September. It is unclear whether the Senate will act on this legislation during the lame duck session, but these bills are also likely to be under consideration when another continuing resolution is addressed.

Online sales tax legislation update

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. The framework for sales taxes the Supreme Court affirmed in 1992 resulted in no taxes being applied on sellers that lack a physical presence in the state, but the growth of internet commerce has complicated this issue. Internet retailers have a price advantage by shipping goods into states without opening physical locations there – with local retailers losing business to the competition and states losing tax revenue. A bipartisan coalition formed to support the idea of letting states tax those sales, and the Senate passed legislation in 2013, but it has stalled in the House. It is unlikely that this issue can be resolved prior to the end of the year, however, due to the short legislative calendar and the continuing controversy surrounding the issue.

Clinton and Trump plans

Democratic presidential nominee Hillary Clinton and Republican presidential nominee Donald Trump have provided few new details on tax policy during the presidential debates. **Trump's focus** has been on offering companies an incentive to keep jobs in the US (alluding to his repatriation proposal) and providing individual tax cuts that would encourage company owners to expand their businesses, thereby creating jobs. **Clinton's focus** has been on higher taxes on the wealthy with the resulting revenue to be used to "invest" in the middle class through education, infrastructure spending, affordable child care, and advanced manufacturing, while she also discussed eliminating corporate loopholes.

Treasury and the IRS

The IRS issued Rev. Proc. 2016-45, which **lifts the "no-rule" policy** on significant legal issues relating to (1) the corporate business purpose requirement and (2) the device test under **section 355** relating to distributions of stock of controlled corporations. The changes will apply to all requests received on or after August 26, 2016, and will apply to requests that relate to distributions occurring after August 26th, the date of the revenue procedure. The IRS also issued Rev. Proc. 2016-40 that provides two safe harbors under which the IRS will not assert that a corporation lacks the control required under Code section 355(a) when a corporation acquires control of another corporation through the target's issuance of stock followed by certain transactions that reverse the effect of the stock issuance.

The IRS issued Rev. Proc. 2016-48, with **guidance on changes to the depreciation rules** under sections 179 and 168 that were enacted in 2015 by the Protecting Americans from Tax Hikes Act. The guidance includes procedures for making certain elections and filing amended returns.

Ireland has filed a formal appeal to the European Commission's state aid decision that cited Ireland's tax laws as illegally benefiting Apple. Treasury Secretary Lew has been publicly and privately vocal in expressing US criticism of this decision, and a Treasury Department White Paper issued days before the EC decision was announced argued that the EC could be dangerously transformed into a "supra-national tax authority."

In a Wall Street Journal editorial, Secretary Lew commented that the EC's ruling could further erode the US corporate tax base, noting that the bipartisan opposition in Congress to the ruling "may present a new opportunity to make [tax] reform a reality." He agrees with the EC on the broader issue of global tax avoidance, but states that the EC decision imposes "unfair retroactive penalties, is contrary to well-established legal principles, calls into question the tax rules of individual countries, and threatens to undermine the overall business climate in Europe."

He stated that the Administration will continue to make the case to Congress for action on tax reform noting that attention being paid to the EC decision may help to move Congress to act on tax reform early in the next administration.

European Commission State Aid Investigations and US Response

Treasury White Paper on EC State Aid Investigations

The Treasury Department released a white paper titled "The European Commission's Recent State Aid Investigations of Transfer Pricing Rules," which outlines concerns with the investigations and the targeting of US companies. The paper also suggests that the investigations could "undermine and reverse international progress" in developing transfer pricing rules and the OECD BEPS initiative.

The paper states that the investigations have caused the "Commission to second-guess Member State income tax determinations" and were "an unforeseeable departure from the status quo." It criticizes the retroactive recoveries sought by the EC stating that this departs from prior practice, would be inconsistent with EU legal principles, and would undermine the G20's efforts to improve tax certainty setting a bad precedent for tax authorities in other countries.

A major consequence of the ruling is that recoveries ordered "will be considered foreign income taxes that are creditable against US taxes owed by the companies in the United States." The paper notes that in that case, "the companies' US tax liability would be reduced dollar for dollar by these recoveries when their offshore earnings are repatriated or treated as repatriated as part of possible US tax reform." The paper comments that this would effectively transfer tax revenue to the EU from US taxpayers.

Finally, the paper concludes that the EC's actions "undermine the international consensus on transfer pricing standards, call into question the ability of Member States to honor their bilateral tax treaties, and undermine the progress made under the OECD/G20 Base Erosion and Profit Shifting ('BEPS') project." The paper states: "The US Treasury Department continues to consider potential responses should the Commission continue its present course."

Notice 2016-52

Treasury and the IRS issued Notice 2016-52, which announces forthcoming regulations related to certain transactions conducted in anticipation of foreign-initiated income tax adjustments (i.e. EC state aid rulings). The regulations will treat these transactions as foreign tax credit splitter arrangements under Code section 909 applicable to foreign income taxes paid on or after September 15, 2016. Treasury representatives have indicated that the new notice would "close another tax loophole that contributes to the erosion of our tax base," ensuring that corporations can only claim foreign tax credits when they repatriate foreign earnings. Treasury finalized rules in 2015 but have indicated that there were some gaps in the framework. Treasury has not explicitly stated that taxes required by EC state aid cases would be eligible for the foreign tax credit, but if they are, it appears that Treasury believes some corporations would use splitting arrangements to decrease their US tax liability.

Section 909 is intended to prevent the separation of creditable foreign taxes from related income by, in general, deferring the right to claim credits until the related income is included in US taxable income. The IRS explains in the Notice that a corporation facing such a ruling from the EC may make a pre-emptive move to change its ownership or initiate a large distribution "so that the subsequent tax payment creates a high-tax pool of post-1986 undistributed earnings that can be used to generate substantial amounts of foreign taxes deemed paid, without repatriating and including in US taxable income the earnings and profits to which the taxes related."

Notice 2016-52 states that the regulations will "identify two new splitter arrangements relating to section 902 corporations that pay foreign income taxes pursuant to foreign-initiated adjustments." The IRS says the new regulations will treat these transactions as foreign tax credit splitter arrangements under Code section 909. Treasury and the IRS have requested comments on the rules described in the Notice.

International Issues

The OECD released a **discussion draft on "branch mismatch structures"** under Action 2 (Neutralizing the Effects of Hybrid Mismatch Arrangements) of its BEPS action plan. Branch mismatches occur where the jurisdictions in which the head office and a branch office of a taxpayer are located take a different view as to the allocation of income and expenses between the head office and branch office and include situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction. The discussion draft identifies five types of branch mismatches and makes recommendations intended to address each type. Comments were required by September 19th.

In September, the **UK enacted hybrid mismatch legislation** as part of the Finance Act 2016, which will come into effect on January 1, 2017 (with no grandfathering for existing arrangements). The rules are intended to implement the best practice recommendations in the BEPS Final Report under Action 2. The UK is one of the first countries to introduce these recommendations. Hybrid mismatch arrangements are defined as cases where an amount is deductible in one jurisdiction but not taxed in any other jurisdiction (i.e. a deduction & no inclusion mismatch), or where an amount is deductible more than once (a double-deduction mismatch). Under hybrid mismatch rules, deductions are not permitted for payments from the UK to non-UK recipients if the arrangement gives rise to a deduction & no inclusion mismatch, including those that arise because the payee is a company that has one or more permanent establishments.

The **OECD Secretary General** delivered his **report to the G20 leaders** at the fall meeting in China. The two-part report addressed the following: the BEPS project, tax transparency, tax policy tools to support sustainable and inclusive growth, tax and development, as well as a progress report on transparency and exchange of information for tax purposes. The report noted that the Global Forum on Transparency and the Financial Action Task Force would be issuing a report in October 2016 on the provision of beneficial ownership information, essentially as part of the automatic exchange of information under FATCA and the common reporting standard. The Secretary General also noted that it will provide details to the G20 leaders' meeting in 2017 of "uncooperative" jurisdictions, i.e. jurisdictions that essentially are not participating in the automatic exchange of information.

The **OECD** released a **working paper titled "Fiscal Incentives for R&D** and Innovation in a Diverse World." The working paper recommends that fiscal incentives, including tax policies be directed at specific barriers, impediments or synergies to facilitate the desired level of investment in research and development (R&D) and innovations. The working paper concludes that "[m]ore research is needed to determine the extent to which R&D fiscal incentives in one country increase overall R&D, the quality of that R&D, and its positive spillovers to other sectors of the economy and other countries."

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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.