WASHINGTON TAX NEWS

Potomac Law Tax Newsletter—November 2016 Susan Rogers

The November 8th elections will produce major changes in Washington with the **Republicans in charge of the White House, House and Senate** (albeit not with a filibuster-proof margin). The policymaking agenda in Washington will be determined by these changes with clear impacts on developments in the area of tax policy and the future of comprehensive tax reform.

The primary issue facing Congress when they return next week will be to address the **funding of the Federal government**, since the current Continuing Resolution expires on December 9th. Republican Congressional leadership will likely opt to defer other issues until the new year when they can deal with a Republican White House.

There will likely be a push from Capitol Hill Republicans for **full-scale tax reform** based on the blueprint released earlier this year that includes a 20 percent corporate tax rate, while President-elect Trump proposed a tax reform plan with a 15 percent rate on business and other changes that moved closer to the House plan. It seems clear now that 2017 will see a renewed interest in moving comprehensive tax reform, but the question remains as to whether the focus of tax reform would be comprehensive or more targeted at business tax reform. It is possible that Congressional Republicans will look to use the budget reconciliation process as a vehicle for tax reform due to the ability to move that type of legislation without the fear of a filibuster. Also in question is whether the final Code section 385 regulations move ahead as planned in light of the election results.

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

As a result of the November 8th elections, Washington will now see one-party rule for the first time since 2010, and the expectation is that the Republican leadership in Congress will plan to move expeditiously on key legislation early in 2017 to capitalize on working with a Republican White House.

Susan Rogers

In This Issue

Treasury and the IRS Update

Regulations on Partnership Disguised Sales and Liability Allocations

The IRS issued a package of regulations related to **disguised sales** under Code section 707(a)(2)(B) and the **characterization of partnership liabilities as recourse or non-recourse** under Code section 752. The package includes final regulations, temporary regulations, proposed regulations, and re-proposed regulations.

The first regulation provides final rules under Code section 707 covering disguised sales of property to or by a partnership and final rules under Code section 752 on allocations of excess nonrecourse liabilities of a partnership to partners for disguised sale purposes. Also released were final and temporary regulations on the allocation of liabilities for purposes of Code section 707 and when certain obligations are recognized for purposes of determining if a liability is a recourse partnership liability under Code section 752. Finally, the IRS released a proposed rule that addresses when certain obligations to restore a deficit balance in a partner's capital account are disregarded under Code section 704 and when partnership liabilities are treated as recourse liabilities under Code section 752.

The most notable change with respect to disguised sales is included in the temporary and proposed regulations and requires the allocation of a partnership liability to be made in accordance with the manner in which the partners share profits of the partnership, regardless of whether such liability otherwise meets the definition of a recourse liability that is allocable in any other manner. With respect to the general partnership liability allocation rules under Code section 752, the proposed regulations had introduced a set of contractual and net worth factors to be satisfied in order for a partnership liability to be classified a recourse liability and allocable to a specific partner under the "risk-of-loss" test, but these proposed regulations were withdrawn and re-proposed with those factors becoming a new facts and circumstances anti-abuse rule.

Other Guidance

The IRS issued final regulations clarifying the **disallowance of the research and development credit for software that is developed by a taxpayer primarily for internal use**. The rules narrow the definition of internal use software to be defined as software used for human resources, support services, and financial management, but also covering a broad range of issues including the list of general and administrative functions, dual functions, interactions and connectivity with third parties, and software that is commercially sold, leased, licensed or otherwise marketed to third parties. The final rules include 18 examples illustrating its application.

The IRS issued final and temporary regulations that extend the due date (by six months) by which a taxpayer may elect under Code section 165(i) to treat a **loss attributable to a federally declared disaster** as sustained in the prior tax year. The temporary regulations were made effective immediately because the Federal Government expects a significant number of casualty losses due to recent flooding events. The IRS also issued Revenue Procedure 2016-53 specifying how to make this election and how to take consistent return

Miscellaneous Issues

The US Supreme Court denied certiorari in *Gillette v. Franchise Tax Board*, the **leading case on whether an out-of-state business can elect to apportion its business income** under the Multistate Tax Compact's evenly weighted three-factor formula. The Court's decision not to hear the case means that the California Supreme Court's 2015 holding will stand, where the court held that the state could enforce its statutory apportionment formula instead of the compact's formula, despite the state's adoption of the compact.

Prior to leaving Washington for the election recess, the House passed the **Mobile Workforce State Income Tax Simplification Act**, which would restrict states from imposing income tax on nonresidents, unless the individual works in that state for more than 30 days during the year. A similar version of this bill passed the House in 2012, but was never voted on in the Senate. A current and identical companion bill in the Senate has more support than the 2012 legislation, but challenges remain to passage in the Senate.

Earlier this year, the Treasury Department and IRS proposed sweeping regulations 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 jurisdiction with lower tax rates. The proposed regulations under Code section 385 were designed to treat certain instruments that were purportedly debt as stock in order to address this perceived erosion of the US tax base.

On October 13th, Treasury and the IRS issued final, temporary and proposed regulations replacing the earlier proposed rules. The original proposed regulations garnered significant comment and criticism, and the final regulations, which are significantly narrower in scope, reflect changes that appear to respond to comments received by the Government from taxpayers. At a background briefing, Treasury officials estimated that the final rules will raise from $600-700 million annually.

A senior IRS official has commented that the agency expects there will be legal challenges to the final regulations. The preamble includes material responding to nearly 150 comments about specific issues in the regulations in an effort to address legal challenges.

<u>Section 385 Final Regulations—Congressional Reaction</u>

In commenting on the final rules, Treasury Secretary Lew stated that problems like inversions and earnings stripping cannot be solved by administrative action alone and that the "real solution is for Congress to enact comprehensive business tax reform with specific anti-inversion and earnings stripping provisions." He indicated that for the remainder of the Obama Administration, Treasury would continue to make the case for business tax reform, and that recent developments, such as the European Commission's State aid investigations, have brought "additional attention to this issue."

<u>Congressional Reaction</u>

House Ways & Means Committee Chair Kevin Brady (R-TX) reacted to the final rules by stating that, "American businesses and Members of Congress from both sides of the aisle have repeatedly asked the Administration to slow down and do the work necessary to ensure that final regulations under section 385 will not damage our economy and hurt American workers. By rushing the review process – despite the extensive comments received – and finalizing these regulations so quickly, it appears that the Obama Administration has ignored the real concerns of people who will be most impacted by these far-reaching rules. I am going to carefully review these final regulations in the days ahead and hear directly from people across America about how these rules will impact our workers, our job creators, and our communities."

Senate Finance Committee Chair Orrin Hatch (R-UT) also released a statement indicating that he would have preferred Treasury re-propose the rules. "Since the day the regulations were first proposed, the Treasury Department has heard pointed concerns from both Republicans and Democrats, and from numerous American job creators and a wide variety of sectors across the US economy that proceeding with the rules would be ill-advised and lead to unintended consequences for America's innovators. While the final regulations will need to be scrutinized closely, it is immensely concerning that, despite stark bipartisan concern, the Obama Administration moved forward with completing rules that could jeopardize American businesses and the economy here at home."

The final regulations drew support from the **Ranking W&M Democrat, Sander Levin** (D-MI), who commented that "these regulations are another significant step the Administration has taken to restore fairness to the tax system and ensure multinational corporations pay their fair share of taxes." In a statement, he said "For years, companies have been inverting and engaging in earning stripping to unfairly lower their tax bills. In the absence of Republican action on tax reform, Treasury has used its Administrative authority to help bring fairness to the tax system."

SFC Ranking Democrat Senator Ron Wyden (D-OR) also praised the final Treasury regulations, but agreed that Congress needs to act. In a statement, he said "These final rules on Section 385 clearly reflect a lot of input and careful study, and in my view they will go a long way to protecting our corporate tax base. What this does not change is the need for tax reform. For too long Congress has sat on a broken and outdated tax system, which is why the US has resorted to rule changes to respond to wave after wave of tax avoidance. The answer is for Congress to reform the tax code on a bipartisan basis."

International Issues

OECD Base Erosion and Profit Shifting (BEPS) Project Update

The OECD issued a new report outlining several mechanisms that member nations will implement to resolve treaty-related disputes in a timely, effective and efficient manner. These documents form the basis of the **Mutual Agreement Procedure (MAP) peer review and monitoring process** under Action 14 of the BEPS Action Plan. Recognizing that the actions to counter BEPS must be complemented with actions that ensure certainty and predictability for business, Action 14 calls for effective dispute resolution mechanisms to resolve tax treaty-related disputes. The compilation includes the Terms of Reference which translate the minimum standards approved in the final Action 14 report into a basis for peer review; the Assessment Methodology for the peer review and monitoring process and the MAP statistics reporting framework which reflects the collaborative approach competent authorities will take to resolve MAP cases and which will ensure greater transparency on statistical information relating to the inventory, types and outcome of MAP cases through common reporting of MAP cases going forward; and Guidance on information and documentation to be submitted with a MAP request.

OECD

As a further step to implement the **OECD Common Reporting Standard** (CRS), the first series of bilateral automatic exchange relationships were established among the first group of jurisdictions committed to exchanging information automatically as of 2017. With a year to go before the first exchanges of information on financial accounts pursuant to the OECD CRS, there are now more than 1000 bilateral relationships in place globally, most of them based on the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (the CRS MCAA).

European Commission

As part of a broader package of corporate tax reforms, the European Commission (EC) published a proposal for a Council Directive on a **Common Consolidated Corporate Tax Base** (CCCTB) which would apply to all groups of companies with total annual turnover in excess of EUR 750 million and a taxable presence in at least one European Union (EU) Member State. The CCCTB includes a tool for attributing income to where the value is created, through a formula based on three equally weighted factors (i.e., assets, labor, and sales). The proposal states that a new framework is needed for a fair and efficient taxation of corporate profits in light of Europe's priority to promote sustainable growth and investment within a fair and integrated market.

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

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