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U.S. Supreme Court Hears Oral Arguments in *South Dakota v. Wayfair*

In what was perhaps the most anticipated event to occur in the field of state and local taxation over the past 26 years, on April 17, 2018, the U.S. Supreme Court held oral arguments in *South Dakota v. Wayfair, Inc. et al.,* Docket No. 17-494. The Court is reconsidering the physical presence nexus standard first established by the Court over 50 years ago in *National Bellas Hess v. Illinois*, 386 U.S. 753 (1967) and later affirmed with respect to Commerce Clause nexus in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The Court's decision, which is expected by the end of June, could have a profound impact on the retail industry in the United States by altering the limitations currently imposed on a state's ability to require out-of-state retailers to collect and remit the state's sales and use tax. A full repeal of the physical presence nexus standard by the Court could drastically reshape the e-commerce landscape as we know it and potentially trigger a significant amount of litigation aimed at defining a new nexus standard.

With several members of Congress in attendance, the Court bombarded both sides with difficult questions on issues ranging from the appropriate constitutional nexus standard to the impact that a full repeal of the physical presence standard would have on small businesses. One major concern among several members of the bench was the potential problem of states retroactively pursuing historical sales and use tax liabilities from retailers without an in-state physical presence, should the physical presence standard be overruled by the Court. Another theme that the justices revisited throughout their questioning was whether Congress — as opposed to the Court — was the appropriate body to remedy any perceived sales tax collection problems created by the physical presence standard, particularly given that Congress potentially could address the retroactivity issue.

In sum, the oral arguments reflected a Court that appears to be much more divided than many in the state tax community had initially expected after the Court granted certiorari. The Supreme Court's granting of *cert.* in this case was interpreted by many as a signal from the Court that it was likely to overturn this precedent – and it still may do so – but based on last month's oral arguments, the fate of the physical presence standard is far from certain. Further insight into the *South Dakota v. Wayfair* oral arguments will be forthcoming on the SALT

Savvy blog in anticipation of the Court's upcoming decision in the case. *See* *U.S. Supreme Court Hears Oral Arguments in South Dakota v. Wayfair* at www.saltsavvy.com.

By: David Pope and Michael Tedesco, New York

Treasury Provides Initial Guidance Under Section 163(j)

On April 2, Treasury issued preliminary guidance with respect to Code Section 163(j), as amended by the Tax Cuts and Jobs Act ("TCJA"). Notice 2018-28 details Treasury's intended path for regulations with respect to the new interest expense limitation regime and specifically addresses carryforwards from pre-TCJA taxable years, whether C corporations have investment interest expense, and the application to consolidated groups, among other items. While the notice announces some of Treasury's key decisions with respect to section 163(j), it also highlights that there is a great deal of work still to be done. Certain decisions, such as implementing the section 163(j) limitation at the level of the consolidated group, will require extensive guidance, and Treasury has called for comments on these open issues.

Overview of the TCJA's Modifications of Section 163(j)

Prior to amendment by the TCJA, section 163(j) limited a corporation's interest deductions if (1) the corporation's net interest expense exceeded 50 percent of the corporation's adjusted taxable income (*i.e.*, income without respect to certain deductions such as NOLs, depreciation and amortization, among other items), plus any excess limitation carryforward, and (2) the corporation had a debt to equity ratio in excess of 1.5 to 1. This limitation applied only to related party interest payments where the resulting interest income was taxed in the United States. This limitation also extended to interest on indebtedness guaranteed by a related party and interest paid by a taxable REIT subsidiary to a REIT.

The TCJA broadened the scope of section 163(j)'s limitation significantly. While the prior provision applied only to corporations and foreign corporations engaged in a US trade or business, the new provision also applies the limitation to individuals and partnerships. In addition, new section 163(j) applies to interest paid to both related and unrelated parties. Section 163(j) now limits deductions for business interest to 30 percent of the taxpayer's adjusted taxable income, plus any business interest income. For this purpose, "adjusted taxable income" ("ATI") is now generally equivalent to earnings before interest, taxes, depreciation and amortization ("EBITDA"). For taxable years beginning on or after January 1, 2022, taxpayers must add back depreciation, amortization, and depletion, meaning that ATI will then equal earnings before interest and taxes ("EBIT").

Upcoming Tax Events

15th Annual Global Tax Planning and Transactions Workshop

New York, NY
► May 23, 2018

Baker McKenzie and Bloomberg Tax Global Transfer Pricing Conference

Washington, DC
► June 6-7, 2018

Register with corporate guest code BAKDC18

Global Tax Controversy Following US Tax Reform

New York, NY
► June 19, 2018

Pre-TCJA Carry Forwards

When amending section 163(j), Congress was notably silent with respect to the transition between the old and new interest limitation regimes. Section 3 of Notice 2018-28 addresses some of the open questions about how taxpayers should transition into the new interest limitation regime, particularly with respect to interest disqualified in pre-TCJA taxable years. Prior to amendment, section 163(j) allowed taxpayers to carryforward disallowed interest indefinitely. While section 163(j), as amended, similarly allows for indefinite carryforward of disallowed interest, the new provision is silent with respect to pre-TCJA amounts. According to the notice, Treasury intends to issue regulations which allow taxpayers to carry previously disallowed interest forward as business interest to the taxpayer's first taxable year beginning after 31 December 2017. However, that interest carried forward is subject to the same potential disallowance as business interest paid or accrued in post-TCJA taxable years.

This welcome development with respect to pre-TCJA disallowed interest is perhaps offset by Treasury's position on the application of the Base Erosion and Anti-Abuse Tax ("BEAT") to the interest carried forward from pre-TCJA years. The notice states that Treasury intends to issue regulations which would subject pre-TCJA, carried forward interest to the BEAT. This means that if the pre-TCJA interest payments were paid or accrued to a foreign related person, such payments will be treated as base erosion payments for purposes of the BEAT. As a result, interest expense incurred prior to the enactment of the TCJA will be pulled into the scope of the new law when carried forward to a post-TCJA taxable year, adding yet another wrinkle in the already-complex BEAT calculation.

Notice 2018-28 also addresses the carryforward of the excess interest limitation. Under prior law, if a corporation did not have "excess interest expense" – *i.e.* its net interest income did not exceed 50 percent of its adjusted taxable income – the taxpayer could carryforward its excess interest limitation capacity. For purposes of determining whether a taxpayer had excess interest expense in subsequent years, a taxpayer could add the amount by which 50 percent of the taxpayer's adjusted taxable income exceeded the taxpayer's net interest expense in the prior year to 50 percent of the taxpayer's adjusted taxable income in the current year. The ability to carryforward the excess interest limitation capacity therefore decreased the limitation. Congress did not include an analogous carryforward provision under the new section 163(j). Because no such carryforward exists under the new law, it is Treasury's intent to issue regulations disallowing the carryforward of any pre-TCJA excess limitation to post-TCJA taxable years.

Treasury's approach with respect to interest and excess limitation carryforwards may provide insight with respect to other forthcoming transitional guidance. Treasury appears to be willing to carryforward a tax attribute if such carryforward exists under the new law, such as the indefinite interest carryforward. However, where Congress did not continue such treatment, Treasury appears comfortable with denying transitional relief and extinguishing existing tax attributes. In

addition, Treasury's decision to apply the BEAT to pre-TCJA, carried forward interest, and subject such interest to the same disallowance as interest expense generated in post-TCJA taxable years, indicates that Treasury will seek to narrow its grandfathering. As a result, it is unlikely Treasury will allow new and old regimes to operate in parallel over a transitional period.

Business and Investment Interest For C Corporations

The new section 163(j) applies to "business interest" – a term not previously used in section 163(j) due to its focus on "disqualified interest." The new provision defines business interest as interest that is not investment interest under section 163(d), which limits investment interest deductions for taxpayers other than corporations to the taxpayer's net investment income. This created some uncertainty for corporations as to whether they would have to bifurcate business and investment interest for purposes of section 163(j). The notice states that Treasury has decided to follow the legislative history of the prior House version of the TCJA, which stated that corporations have neither investment interest nor investment income. As a result, all interest expense of a corporation should be considered "business interest" for purposes of section 163(j).

Application to Consolidated Groups

Prior to amendment, section 163(j) treated members of an affiliated group, as defined by section 1504(a), as one taxpayer. In 1991, the IRS issued Proposed Treasury Regulation Section 1.163(j)-5, which established the "expanded affiliated group" approach for application of the section 163(j) limitation to corporate groups. The proposed regulations modified the definition of affiliated groups under section 1504(a) by applying the attribution rules of section 318 to determine stock ownership. This modification allowed two different consolidated groups owned by a single parent to be treated as a single taxpayer for purposes of applying section 163(j).

Both the provision treating members of an affiliated group as a single taxpayer and the provision granting the regulatory authority under which the 1991 proposed regulations were promulgated were removed from section 163(j) under the TCJA. Treasury therefore intends to issue regulations requiring that section 163(j) be applied at the level of the consolidated group. As a result, a consolidated group will use its consolidated taxable income for purposes of calculating its adjusted taxable income, and intercompany obligations will be disregarded for purposes of section 163(j).

The notice highlights several issues specific to consolidated groups which will be addressed in forthcoming regulations without details of Treasury's intended approach. These topics include: the allocation of the section 163(j) limitation to group members; the treatment of disallowed interest deduction carryforwards when a member leaves a group; the treatment of disallowed interest deduction carryforwards of a member that joins the group (including whether they are subject to a separate return limitation year (SRLY) limitation; adjustments to the

basis of stock of a subsidiary owned by another member; and application to consolidated groups with members which hold an interest in a non-corporate entity. The notice indicates that Treasury does not anticipate that these regulations will include a general rule to treat an affiliated group that does not file a consolidated return as a single taxpayer. However, this leaves open the possibility that there may be an election to treat an affiliated group that does not file a consolidated return as a single taxpayer.

Questions Left Unanswered

As a mere notice of anticipated rulemaking, Notice 2018-28 serves as only a stop-gap measure in absence of comprehensive guidance. Treasury still has several items to address, including whether section 163(j) will apply to controlled foreign corporations. The current proposed regulations limit the scope of the provision to foreign corporations with income effectively connected with the conduct of a US trade or business, yet Treasury intends to withdraw the proposed regulations. Other items to be addressed include: (1) whether section 163(j) will be applied after any interest denial, deferral, or capitalization rules have been applied, as suggested in the House report; (2) whether deductions taken under the new full expensing provisions will be treated as “depreciation or amortization” for purposes of determining ATI; and (3) how the limitation will interact with other new provisions such as GILTI and FDII, particularly with respect to calculating ATI. If taxpayers or industries find that guidance with respect to these issues would have a significant impact on their tax position, they should consider providing examples and suggestions to Treasury in the coming months to better shape the forthcoming regulations.

By: Josh Odintz, Jen Molnar, Alexandra Minkovich and Katie Rimpfel, Washington, DC

Continuity of Value: Rev. Proc. 2018-12 Provides Safe Harbor for Valuing Stock for Continuity of Interest Purposes

Rev. Proc. 2018-12 (“the Rev. Proc.”), effective with respect to transactions with an effective date on or after January 23, 2018, provides a safe harbor to determine whether the continuity of interest (“COI”) requirement is satisfied in a potential section 368(a) reorganization. In order for a taxpayer to meet the requirements for non-recognition treatment for certain reorganizations, the COI requirement under Treas. Reg. § 1.368-1(e) must be met. The COI requirement prevents transactions that resemble sales from qualifying for tax-free treatment by requiring the target shareholders to receive a portion of their consideration for disposing of the target corporation shares in the form of issuing corporation stock (which depending on the type of reorganization can be either stock of the acquiring corporation or stock of the corporation in control of the acquiring corporation). Requiring that the target shareholders receive issuing corporation stock as a portion of the consideration ensures that the target shareholders maintain a proprietary interest in the target corporation, thereby justifying tax-free

treatment of the transaction. To determine whether the COI requirement is satisfied, the value of the issuing corporation stock received by the target shareholders is measured against the aggregate value of all consideration received by the target shareholders. Example 1 in Treas. Reg. § 1.368-1(e)(2)(v) has been understood to imply that at least 40 percent of the total value of the consideration received by the target shareholders should be comprised of stock of the issuing corporation (some judicial decisions pre-dating the promulgation of Treas. Reg. § 1.368-1(e) have allowed for less than 40 percent of the consideration value to be comprised of issuing corporation stock). This gives rise to the question of when and how to value the stock of the issuing corporation, and Rev. Proc. 2018-12 provides some clarity for publicly traded issuing corporations.

Prior to the promulgation of Treas. Reg. § 1.368-1(e), the determination of whether the COI requirement was satisfied had been based on the value of the issuing corporation stock as of the closing date of the transaction (the "Closing Date Rule"). If the Closing Date Rule applied to a transaction, a decline in the value of the issuing corporation stock between the signing date (the date the contract to effect a potential reorganization becomes binding) and the closing date could cause a transaction to fail the COI requirement. Recognizing the uncertainty this could bring to taxpayers, the final regulations under Treas. Reg. § 1.368-1(e) included the "Signing Date Rule" (Treas. Reg. § 1.368-1(e)(2)). The Signing Date Rule applies to situations where there is a binding contract to effect a potential reorganization and the contract provides for fixed consideration to be exchanged for proprietary interests of the target shareholders. If the Signing Date Rule applies to a transaction, the consideration is valued as of the end of the last business day before there is a binding contract (the "Pre-Signing Date"), rather than on the closing date. Thus, a change in the value of the issuing corporation stock to be received by the target shareholders between the signing date and the closing date, does not affect the determination of whether the COI requirement has been met. Proposed Regulations were issued in 2011 to identify and address situations other than those covered by the Signing Date Rule, and although final regulations were not issued, the Rev. Proc. seeks to address some of these situations by providing certain "Safe Harbor Valuation Methods" and "Measuring Periods."

There are a number of requirements that must be met in order for a taxpayer to apply the Rev. Proc., including, among others: (i) the target shareholders receive issuing corporation stock and other consideration that apart from the COI requirement would qualify the transaction as a reorganization described in sections 368(a)(1)(A), (B) or (C), or a section 368(a)(1)(G) reorganization to which section 354, or so much of section 356 as relates to section 354, applies; (ii) shares of one or more classes of issuing corporation stock that are exchanged for target shareholder stock are traded on a national securities exchange registered with the Securities and Exchange Commission (referred to as "Exchange Traded Stock"); and (iii) all parties to the reorganization treat the transaction consistently (i.e., either qualifying or not qualify as a reorganization).

The Rev. Proc. provides Safe Harbor Valuation Methods and Measuring Periods that taxpayers may use to avail themselves of the safe harbor to determine the value of Exchange Traded Stock. The safe harbor is only available if the transaction satisfies all of the requirements in the Rev. Proc and if one of three Safe Harbor Valuation Methods that uses an appropriate Measuring Period is used to determine the value of Exchange Traded Stock. The three Safe Harbor Valuation Methods are: (i) "Average of the Daily Volume Weighted Average Prices"; (ii) "Average of the Average High-Low Daily Prices"; and (iii) "Average of the Daily Closing Prices". The Average of the Daily Volume Weighted Average Prices method allows the taxpayer to use the average of the daily volume weighted average prices of a share of a class of Exchange Traded Stock on the specified exchange as determined on each day of the Measuring Period. The Average of the Average High-Low Daily Prices method allows the taxpayer to use the average of the daily average high-low trading prices of a share of a class of Exchange Traded Stock on the specified exchange as determined on each day of the Measuring Period. Finally, the Average of the Daily Closing Prices method allows the taxpayer to use the average of the daily closing prices of a share of a class of Exchange Traded Stock on the specified exchange as determined on each day of the Measuring Period. Whichever valuation method is chosen is applied separately for each class of Exchange Traded Stock received by the target shareholders.

The Measuring Period is the chosen number of consecutive trading days (based on the trading schedule of the specified exchange) used in connection with one of the Safe Harbor Valuation Methods described above. The Measuring Period used to determine the value of a share of each class of Exchange Traded Stock must be at least five, but not more than thirty-five consecutive trading days. The Measuring Period must end no later than the Closing Date, if the Closing Date is a trading day on the specified exchange, and if it is not, the Measuring Period must end no later than the last trading day before the Closing Date. If the Signing Date Rule applies to the transaction, the Measuring Period cannot end earlier than three days before the Pre-Signing Date and if the Closing Date Rule applies to the transaction, the Measuring Period cannot end earlier than three days before the Closing Date.

If all of the requirements of the Rev. Proc. are satisfied, the IRS will not challenge the position that for purposes of determining whether the COI requirement is satisfied, the value of Exchange Traded Stock is determined under the Safe Harbor Valuation Method and Measuring Period selected by the parties. The Safe Harbor is available to determine the value regardless of whether the value of Exchange Traded Stock ultimately satisfies the COI requirement.

By: Kia Waxman, New York

IRS Reinforces Position on Consequences of Distributing Company Restructurings While Turning Its Attention to Spin-off Costs

On February 2, 2018, the IRS released private letter ruling ("PLR") 201805012 in which it reaffirmed its position that transactions contemplated as part of the restructuring of a distributing corporation in bankruptcy will not prevent the transactions from qualifying as a Type G reorganization or the distribution from qualifying as a distribution under Section 355. Just one month after issuing this ruling, the IRS Large Business and International Division ("LB&I") made a commitment to scrutinizing the costs of Code Section 355 transactions under its compliance campaigns (discussed hereinafter), which are meant to facilitate issue-based examinations and compliance.

Overview

PLR 201805012 (Feb. 2, 2018) was issued as a supplemental ruling to PLR 201743017 (Oct. 30, 2017), which was issued as the first supplemental ruling to PLR 201644018 (Oct. 28, 2016).

PLR 201644018

The facts of this PLR involved a complex debt restructuring related to a group of entities parented by Distributing corporation. The group was under Bankruptcy Court supervision, and had (for more than 5 years) conducted two businesses: Business 1, which was conducted through a chain of its subsidiaries including LLC 2 and a controlled subsidiary ("Controlled"), and Business 2, which was conducted through a chain of its subsidiaries including LLC 7. LLC 2 was a disregarded entity with a significant amount of outstanding debt. As part of the complex restructuring, Distributing proposed to spin off all stock of Controlled under Section 355 to the creditors of LLC 2 in a Type G bankruptcy reorganization. Distributing would continue to conduct Business 2, and Controlled would continue to conduct Business 1.

In order to qualify as a Type G reorganization (*i.e.*, a reorganization under Section 368(a)(1)(G)), the following three requirements must be met: (i) a corporation must transfer all or part of its assets to an acquiring corporation; (ii) the transfer must be made in a Title 11 bankruptcy or similar case; and (iii) stock or securities of the acquiring corporation must be distributed in a transaction which qualifies under Section 355 (or Sections 354 or 356). As with all tax-free corporate divisions, Section 355 requires that a continuity of interest exist—that is, a continuity of ownership among one or more persons who, directly or indirectly, owned the enterprise before the distribution. This requirement applies to the distributing corporation and the distributed corporation. Thus, the question arose whether the creditors of LLC 2 could be treated as owners of the enterprise for purposes of satisfying the continuity of interest requirement under Section 355.

The IRS ruled, among other things, that when Distributing spun off Controlled, the creditors of LLC 2 *could* be treated as owners of the enterprise. Notably the IRS also ruled that, because Distributing was not personally liable on any potion of the LLC 2 debt, it was a nonrecourse liability, meaning that its cancellation in the distribution resulted in an amount realized under Section 1001. Thus, their interests were taken into account in determining whether the continuity of interest requirement under Section 355 was met. Accordingly, the reorganization qualified under Section 368(a)(1)(G).

PLR 201743017

PLR 201743017 supplemented the facts to provide that, pursuant to the plan of reorganization (confirmed by the Bankruptcy Court), the proposed transaction effecting the separation of Distributing's Businesses 1 and 2 was completed. Additionally, Distributing and its subsidiary LLC 7 remain under the jurisdiction of the Bankruptcy Court and any transactions that Distributing and LLC 7 undertake with respect to their remaining assets, subsidiaries, and outstanding debt, have not yet been confirmed by the Bankruptcy Court.

The IRS ruled that the Distribution (*i.e.*, the transfers by LLC 2 to its creditors of assets including all Controlled stock, and to its administrative and priority claimants) was not used principally as a device for the distribution of earnings and profits of Distributing or Controlled because (i) the Controlled stock was distributed solely to LLC 2's first lien creditors in the Title 11 case, (ii) the amount received by such creditors was significantly less than the principal amount of the debt, and (iii) it is anticipated that the stock of Distributing's shareholders in Distributing will be cancelled for no consideration in any subsequent restructuring of Distributing and LLC 7 in the Bankruptcy proceeding.

PLR 201805012

The February 2018 PLR is the second supplemental ruling, and introduces the additional fact that Business 2 has been the subject of significant interest by unrelated parties and that, at various points since entering into bankruptcy, Distributing and LLC 7 in conjunction with their creditors have considered alternative plans of reorganization to facilitate a path out of bankruptcy (*e.g.*, converting the creditors' claims into equity alone or in combination with funds for additional equity). As a result of this interest, and following the events of the prior PLRs, Distributing contemplates entering into an agreement with an acquiring entity ("Acquiror"), under which a newly formed indirect subsidiary of Acquiror will merge with and into Distributing with Distributing surviving as a new indirect subsidiary of Acquiror (the "Distributing Acquisition"). The merger consideration will consist of the cash proceeds of a contribution made by Acquiror down the chain to Merger Sub (the "Merger Consideration"). In addition, to the extent that the entity directly engaged in Business 2 makes a distribution (during a specified period of time), the parties agree that a portion of such distribution may be sent to a distribution account for the benefit of claim holders. Distributing's entrance into this agreement is approved by the Bankruptcy Court, and the Distributing Acquisition is subject to various conditions (*e.g.*, approval by the Commission).

The PLR provides that the supplemental information and the transactions contemplated therein have no effect on the continued validity of the rulings contained in the initial PLR and the first supplemental PLR. Accordingly, all such rulings remain in full force and effect. Thus, it remains the case that transactions contemplated in restructuring a distributing corporation in bankruptcy will not prevent the transactions from qualifying as a Type G reorganization or the distribution from qualifying as a distribution under Section 355.

355 Compliance Campaign

In January 2017, the LB&I announced its identification and selection of the first 13 issue-focused compliance campaigns as part of its ongoing effort to build a supportive infrastructure inside LB&I. Since then, 16 additional compliance campaigns have been added, including an announcement in March 2018 that the "Costs that Facilitate an IRC Section 355 Transaction" is one of LB&I's issues of focus, despite the scarcity of guidance on how taxpayers should actually go about capitalizing such costs. *See* *IRS Announces Rollout of Five Large Business and International Compliance Campaigns*, March 13 2018; *IRS Announces Rollout of 11 Large Business and International Compliance Campaigns*, November 7, 2017.

The Take Away

While PLR 201805012 has likely laid to rest many questions regarding the application of section 355 to transactions contemplated in restructuring distributing corporations in bankruptcy, taxpayers engaging in such transactions are not free from worry, as noted by the IRS's reinvigorated attention on costs associated with all section 355 transactions.

By: Glenn Fox and Adam Brownstone, New York

OECD and European Commission Release Reports on the Digital Economy; United States Confirms Its Stance

The OECD, European Commission ("EC"), and United States recently publicized their current perspectives on taxation of the digital economy. Addressing the related challenges, let alone the divergent views, remains the subject of heated debate in the tax world.

The OECD's Assessment

On March 16, 2018, the OECD released its *Tax Challenges Arising from Digitalisation – Interim Report* (the "Interim Report"), which was prepared for the G20 Finance Ministers by the OECD's Task Force on Digital Economy ("TFDE"). This is a follow up to the 2015 BEPS Action 1 Report, which grappled with international taxation challenges of the digital economy. The Interim Report represents recent work by the TFDE, and broadly, the more than 110 member countries that have joined the Inclusive Framework (the "Members").

The Interim Report notes that, while it is still early in the process, evidence suggests that countries are achieving widespread implementation of BEPS measures, which is already having an impact. For example, some high-profile digitalized companies have started modifying their structures from remote sales models to local reseller models. Further, multinationals have begun taking steps to align their corporate structures with their real economic activity, either through reconsideration of transfer pricing policies and/or by relocating assets such as intangibles to locations where substantial economic activities take place. There are also strengthened CFC rules and anti-hybrid rules through tax reform in the United States, Japan, and the EU. That said, the impact of BEPS measures are much less evident for the broader tax challenges raised by digitalization (*i.e.*, nexus, data, and characterization) because the relevant measures were largely designed to target double non-taxation rather than the systematic tax challenges posed by digitalization.

The Members have differing views on whether the international tax rules should be modified to account for features of highly digitalized business models (*i.e.*, cross-jurisdictional scale without mass, heavy reliance on intangibles, and data and user participation), particularly with respect to the impact of data collection and analysis and user participation on value creation. The first group is of the opinion that data and user participation can create misalignments between the location where the profits are taxed and where the value is created. This group believes that the challenges are confined to certain business models, and that there is no need for wide-ranging change to the existing international tax rules. The second group takes the view that the digital transformation of the economy (and, more generally, globalization) puts pressure on the existing international tax rules, which is not exclusive or specific to highly digitalized business models. The third group believes the BEPS package largely addressed the double non-taxation, though it is still too early to evaluate the full impact of all measures. This group does not currently see the need for significant reform of the international tax rules. The Members have agreed to take into account these conflicting views as they analyze the two key aspects of the existing framework, the nexus and profit allocation rules, and seek a consensus-based solution.

Change does not happen overnight. Developing, agreeing, and implementing a global consensus-based solution will take much time and effort, but some Members are considering more immediate action through interim measures (e.g., an excise tax or equalization levy on certain online activity). The Interim Report discusses numerous considerations for the design of interim measures that should be taken into account by Members considering such measures, including: compliance with a country's international obligations; being temporary; being targeted; minimizing over-taxation; minimizing impact on start-ups, business creation, and small businesses; and minimizing cost and complexity. Other Members are explicitly against interim measures despite any limitations that may be imposed as they could potentially create adverse consequences. The Interim Report is clear, however, that "there is no consensus on the need for, or the merit of, interim measures, and therefore [the Interim Report] does not make a recommendation for their introduction."

As the Interim Report indicates, more work is on the horizon. The Interim Report, along with an update to the G20 in 2019, are stepping stones toward the TFDE providing a consensus-based approach to digital taxation by 2020. As political pressures mount, the question is, will this work come soon enough to dissuade further unilateral action, or multilateral action such as that recently proposed by the EC?

The EC's Move

In Europe, the BEPS project has found traction with the EC being on the forefront of developing anti-BEPS measure through Directives such as the Anti Tax Avoidance Directives 1 and 2. A new chapter to the EC's efforts was published on March 21, 2018 in the form of two proposals for Directives that lay down new rules for taxing the digital economy. Not coincidentally, these proposals were published just a couple of days after the OECD published the Interim Report.

The first Directive is based on the traditional rules of taxation but proposes to modify the concept of a "brick and mortar" permanent establishment to also identify a taxable presence based on the digital footprint companies may have in a jurisdiction. Since profits also have to be attributed to a taxable presence in order to ensure effective taxation, the proposal incudes a flanking measure introducing a new mechanism for profit allocation. To create this nexus for digital companies, the income from providing digital services, the number of users, or the number of third party contracts to provide digital services in a particular Member State should be taken into account. The EC suggests that to allocate profits to this digital nexus, special attention should be given in the functional analysis to value created through user data and the place where digital services are provided. Further, the allocation of the profits should be done through the profit-split method.

Since the EC acknowledges that implementing the aforementioned rules requires amending applicable double taxation conventions, which entails reaching consensus to effectively apply these rules to non-EU digital companies, the EC also introduced an interim measure in the form of a Digital Service Tax ("DST"). The DST is a 3 percent tax on revenue realized through certain digital business models. This proposed Directive tries to tax revenue created from activities where user input is regarded as one of the main value drivers. At a high level, the following types of business models are considered to be in scope of the DST:

(i) Placing advertising targeted at users on a digital interface.

(ii) Operating a digital multisided interface connecting users and enabling them to interact.

(iii) Transmission of user data generated through user activity on a digital interface.

By setting the threshold for being subject to DST at a worldwide revenue of EUR 750 million and EU revenues of 50 million, the EC targets what it considers to be

the ‘Tech Giants’ without putting undue burden on start- and scale-up businesses. What it does not take into account is the fact that some of the companies meeting these thresholds have a strategy based on acquiring market share rather than being profitable in the initial years. Therefore, the measure that seems to be aimed at making highly digitalized companies pay their fair share of profit taxes could cause companies to be subject to DST without making a dollar of profit.

With the DST proposal, the EC is taking matters into its own hands regardless of the statement in the OECD Interim Report that there is no consensus on the merit or need for interim measures. With the proposal for taxation of digital nexus, the EC is looking to steer the debate into its desired solution. But how likely is it that these proposals will actually come into effect by their desired effective date of January 1, 2020? Under European law, these proposed Directives have to be adopted unanimously in order to pass. In his latest press conference after the ECOFIN meeting in Sofia on April 28, 2018, EU Commissioner Moscovici stated that there is a general willingness to discuss these proposals seriously, and that there still is work to be done to develop the draft Directives into rules that all Member States can agree upon, but that there is a broad basis of support. However, in the aftermath of the ECOFIN meeting it appears that this support for DST may be rather thin, with some of the bigger EU economies reluctant to support a proposal targeted mainly at US multinationals, as this may be regarded a hostile act by the Trump administration. Regardless, Member States may choose to introduce similar rules unilaterally. In any case, it will interesting to follow where this debate is heading.

The United States’ View

Ring-fencing the digital economy has always been concerning for the United States. The United States remains convinced that the debate about the digital economy boils down to the underlying basic principles, such as the definition of a permanent establishment under article 5 of the OECD model tax convention, the profit attribution rules under article 7, and the transfer pricing rules under article 9. While the United States is open to reexamining principles and discussing changes in these areas, it insists that any changes should apply to all businesses and is adamantly opposed to any measures that delineate what the digital economy is and treat digital companies differently from others. In response to proposals in Europe and elsewhere for a digital PE standard on digital transactions, US Treasury Secretary Steven Mnuchin reiterated in a March 16 statement that “[t]he US firmly opposes proposals by any country to single out digital companies,” even though he “fully support[s] international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing.”

The new international tax rules under The Tax Cuts and Jobs Act (P.L. 115-97) may be considered a move aimed at addressing some concerns US trading partners had and proactively implementing the United States’ own solutions to

taxing the foreign profits of US multinationals. Yet crafting a fair system of digital taxation and reaching global consensus on measures to tax the digital economy will continue to be a massive undertaking. Multinationals should closely follow local developments as the OECD continues its work and the pressure from the EU and other taxing authorities around the world continues to grow in the area of digital taxation.

By: Winna Li, Washington, DC,
Kent Stackhouse and Roeland Bavinck, Amsterdam

High Level Overview of the Latest EU Developments for US Multinationals

While the dust is still settling around US tax reform, the European Union is taking its own steps in the field of direct taxation. The following is a high level overview of a few recent tax developments at the EU level that are relevant to US multinationals.

Commission Proposes New Rules to Help Companies Move Across Borders and Find Online Solutions

Most recently, on April 25, 2018, the European Commission ("EC") proposed a new "Company Law Package", which includes two draft Directive proposals which aim to make it easier for EU companies to merge, de-merge or move within the EU without incurring unnecessary burdens and costs, whilst at the same time providing adequate safeguards against abuse.

The first Directive is aimed at adapting EU company law to the digital age, which should enable companies to register, file and update their data in the registers online, without the need of physical presence before a business registry or intermediary.

The second Directive proposal is aimed at improving the cross-border mobility of EU companies, and provides a framework that allows EU companies to merge, de-merge or transfer their registered seat from one EU Member State to another without having to go through liquidation and losing their legal personality. These rules are, however, flanked by anti-abuse rules that set up safeguards to protect the interests of stakeholders such as employees, shareholders and creditors, and to prevent these procedures from being used to set up artificial arrangements, including those aimed at obtaining undue tax advantages. This seems to imply that a new requirement is proposed in that before such a cross border transaction can take place, taxpayers may need to obtain approval confirming the transaction is not aimed at obtaining undue tax advantages. We are following these proposals closely and will be providing updates as plans progress.

EU Directive Proposals on the Taxation of the 'Digital Economy'

On March 21, 2018, the EC published two proposals for taxation of the Digital Economy, which - if adopted - are expected to hit particularly certain US technology companies that do business in the EU. In the proposals, the EC suggests to change the notion of permanent establishments ("PE") to include taxation of a "significant digital presence" by taking into account virtual PEs. Additionally, an interim solution in the form of a Digital Services Tax ("DST") is proposed, given the urgency with which the EC is trying to remedy an alleged lack of taxation of digital companies that derive substantial profits from the EU market. We refer to the article, *OECD and European Commission Release Reports on the Digital Economy; United States Confirms Its Stance*, in this newsletter for more detail on the proposals.

In terms of the latest status update, as of end of April, it seems that the proposals as published cannot count on broad support within the EU, while adoption of such a measure requires unanimous approval. A few EU Member States, including the UK and Germany, have expressed to be against the proposed EU turnover tax on digital businesses for a variety of reasons. While France continues to push for the introduction of the tax, along with a small group of countries including Italy, Poland, Portugal and Spain, as it currently stands unanimous EU action is not going to happen. In that case, countries that remain in favor of the measure will have no option but to introduce it on a unilateral basis into their domestic tax systems.

New Transparency Rules for Intermediaries Involved in Tax Planning

On March 13, 2018, all EU Member States reached political agreement on an amendment of the EU Directive on administrative cooperation in the field of taxation ("Directive"). Under the Directive, intermediaries such as tax advisors, accountants, banks and lawyers must disclose to the local tax authorities potentially aggressive tax planning structures with a cross-border element concerning at least one EU Member State and which reduce the tax burden, as well as arrangements designed to circumvent international reporting requirements ("reportable cross-border arrangements"). In case an intermediary has attorney-client privilege, which is usually the case for attorneys at law, the obligation to report shifts to the taxpayer. The intermediary (or in some cases the taxpayer or client) must disclose a reportable cross-border arrangement within 30 days after such arrangement becomes available to a taxpayer for implementation. The local tax authorities will exchange the information automatically within the EU through a central database.

Aggressive tax planning is purposely not defined. Instead the proposed legislation takes a more "open norm" approach, whereby certain features and elements (so-called hallmarks) of transactions are classified as being reportable. These hallmarks are identified as containing elements of transactions that

present a strong indication of tax avoidance of abuse. Aggressive tax planning includes, for instance, the taking advantage of mismatches in the interaction between two or more tax systems for the purpose of reducing the overall tax liability of a taxpayer or group of companies, and arrangements aimed at circumventing automatic exchange of information.

After formal adoption of the Directive (in all likelihood by mid-2018), EU Member States must implement the Directive in their domestic laws ultimately on December 31, 2019 and apply it as from July 1, 2020. However, it will have retroactive effect and therefore include reportable cross-border arrangements that are implemented as from the date the Directive is formally adopted, which will likely be this summer.

EU Questions Legitimacy of the US Tax Reform

The US Tax Cuts and Jobs Act ("TCJA") as enacted on December 22, 2017 has received strong criticism from the EU, which has argued that certain international parts of the TCJA raise World Trade Organization ("WTO") compliance issues and in addition contravene international principles of taxation. The criticism mainly regards the Base Erosion Anti-Abuse Tax ("BEAT") and the Foreign Derived Intangible Income ("FDII") rules.

In essence, BEAT intends to limit the ability of US companies to strip out taxable profits by making deductible payments to related parties in non-US jurisdictions, by calculating an alternative minimum tax of 10 percent on a taxable basis that - in short- disallows the deduction of said payments. FDII allows US companies to deduct a portion of income derived from exporting of products or services abroad, where the income has a link to intangible assets held in the United States, which deduction reduces the effective tax rate on this income to 13.125 percent instead of the ordinary 21 percent corporate rate. Under the WTO rules, BEAT can potentially be classified as a imposing a hidden tariff or as creating an export subsidy, and FDII can potentially be classified as an export subsidy (incentive to export more goods to obtain a better effective corporate tax rate), as a result of which these rules would not be compatible with WTO rules and may draw international trade challenges. In addition, it can be argued these rules violate the international principle of non-discrimination between foreign and domestic taxpayers, which is also included in the model tax treaties of the US and the Organization for Economic Cooperation and Development ("OECD").

The OECD frequently assesses whether specific country tax regimes constitute harmful tax practices. In March, it became clear that the EU has asked the OECD to investigate with priority whether TCJA is in violation of international standards on harmful tax practices. Although an affirmative conclusion by the OECD on the TCJA is not binding in itself, it is typically an indicator for other jurisdictions for introducing counter measures. As such, the outcome of the OECD analysis may fuel further discussions within the EU Code of Conduct for Business Taxation group on potentially adding the US to the EU blacklisted jurisdictions list (which is partially based on the OECD standards). In addition, the WTO is awaiting the

outcome of the analysis of the OECD to determine whether the BEAT and (mainly) FDII is a "prohibitive subsidy" contingent on export, thus violating the WTO standards. The OECD will also analyze whether FDII creates a tax haven for the US and thus could be subject to EU blacklist.

By: Mounia Benabdallah and Steven Vijverberg, New York

New York's FY19 Budget is "*GILTI*" of Undermining Federal Tax Policy Objectives

The New York FY2019 budget bill ("NY Budget Bill") takes aim at several key provisions in the federal tax reform bill known as the Tax Cuts and Jobs Act ("Federal Tax Reform"). It has been no secret that Governor Cuomo was displeased with Federal Tax Reform, and the NY Budget Bill reflects that displeasure. Among other items, the NY Budget Bill contains two provisions designed to mitigate Federal Tax Reform's limit on the deductibility of state personal income taxes. First, the NY Budget Bill creates state-operated charitable contribution funds and provides taxpayers with a credit against their New York State income tax liability equal to 85 percent of the amounts contributed for the immediately proceeding tax year, and second, the NY Budget Bill creates an optional payroll tax, the Employer Compensation Expense Tax, for which employees will receive a credit against their New York State income tax liability (effectively shifting the tax expense and corresponding deduction from the employees to the employer). The NY Budget Bill also addresses some of the corporate income tax changes adopted under Federal Tax Reform, including Code Section 965 income and the deduction found in Code Section 250(a)(1)(A) for foreign-derived intangible income ("FDII"). Not surprisingly, with respect to the corporate income tax changes and with the exception of section 965 income, the NY Budget Bill essentially conforms to the corporate base-broadening provisions of Federal Tax Reform (e.g., GILTI, limitations on interest deductibility) without adopting any of the corresponding benefits found in Federal Tax Reform (i.e., full and immediate expensing, FDII, and tax rate reductions). The NY Budget Bill was signed into law on April 12, 2018. For more information on the NY Budget Bill, please see *"New York Budget Bill is GILTI of Undermining Federal Tax Policy Objectives"* published on April 11, 2018 at www.saltsavvy.com.

By: Maria Eberle and Lindsay LaCava, New York

U.S. Tax Reform and Impact on Hedge Fund Industry

On December 22, 2017, President Trump signed into law new tax legislation commonly referred to as the "Tax Cuts and Jobs Act" (the "Act"). There are various provisions of the Act that are of relevance to the hedge fund industry, such as: (i) an extended holding period for carried interest; (ii) the 20 percent business deduction with respect to passthrough entities; (iii) new interest

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expense deduction rules; and (iv) new rules on dispositions by foreign persons of interests in partnerships that conduct a US trade or business. For a more thorough discussion, please see the Baker McKenzie Client Alert, "*U.S. Tax Reform: Provisions Of Relevance To Hedge Funds*," distributed on May 8, 2018.

Israeli Supreme Court Rules Stock-Based Compensation to be Included in Cost Base Under Cost-Plus Arrangements

In a ruling handed down in late April 2018, the Israeli Supreme Court sided with the Israel Tax Authority (ITA) and upheld two decisions of the lower District Court in the Kontera Technologies Ltd. and Finisar Israel Ltd. cases, resulting in a potentially increased tax burden for Israeli subsidiaries of multinational companies offering share-based awards to Israeli employees. For a more detailed discussion, please see the client alert *"Israeli Supreme Court Rules Stock-Based Compensation to be Included in Cost Base Under Cost-Plus Arrangements"* distributed on May 15, 2018.

Baker McKenzie and Bloomberg Tax 8th Annual Global Transfer Pricing Conference in Washington, DC

We invite you to join us for the Eighth Annual Global Transfer Pricing Conference, to be held June 6-7 at The National Press Club in Washington, DC. The two-day conference will provide an in-depth look at transfer pricing implications from the Tax Cuts and Jobs Act ("TCJA") on multinational corporations. Our tax practitioners along with corporate transfer pricing professionals, policy makers, and top government and regulatory officials will address how government officials plan to implement the TCJA, how companies are adjusting their transfer pricing strategies, and how the reduced corporate tax rate could impact other countries and WTO rules. Confirmed speakers include:

Government Speakers

- Nikole Flax – Deputy Commissioner, Large Business & International Division, IRS
- Michael McDonald – Former Financial Economist, Office of Tax Analysis, US Department of Treasury
- The Honorable Peter Roskam – Chairman, Tax Policy Subcommittee, House Ways and Means Committee
- Kirsten Wielobob – Deputy Commissioner for Services & Enforcement, IRS

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Corporate Speakers

- American Honda Motor Company, Inc. – Rafael Melo (Senior Transfer Pricing Controller)
- Facebook, Inc. – Alan Lee (Global Tax Policy)
- Fluor Corporation – Mike Barker (International Tax Director)
- Willis Towers Watson – Cynthia Zuk (Director of Global Transfer Pricing)

Agenda and registration details are available at https://www.bna.com/globaltransferpricing-dc/. To receive a reduced rate of $1,095 (regularly $1,395), use Baker McKenzie corporate guest code **BAKDC18** at registration. To receive a discounted rate of $995 for two or more attendees, enter code **GRPDC18**. We hope to see you and your colleagues in Washington, DC!

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For further information regarding the North American Tax Practice Group, any of the items or Upcoming Events appearing in this Newsletter, or to receive *Tax News and Developments* directly, please contact Marie Caylor at 312-861 -8029 or marie.caylor@bakermckenzie.com.

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