

LB&I, INTERNATIONAL UPDATE FOR TEI NEW JERSEY CHAPTER MAY 12, 2017

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AGENDA

- State of affairs at the IRS, LB&I
 - A(nother) new org chart
 - Audit “campaigns” – international flavor
- CBCR implementation
 - OECD
 - US
- Other US C.A. news
- Litigation update
- Side Note #1: Brexit
- Side Note #2: Public tax policy statements

STATE OF AFFAIRS AT IRS, LB&I

Restructuring and Campaigns

THINGS THAT ARE DOWN AT THE IRS

- Agency budget: Down 17% since 2010
- Overall staffing: FTE positions down 17.7% from 2011 to 2016
- Enforcement lost nearly a quarter of its staff, 2010-2016
- Audit rate dropped from 1.1% to 0.7%
- More to go? 40% of workforce eligible to retire by 2019 - !
 - NTEU: Out of 77,000 IRS employees, only 122 full-timers are under the age of 25
- Training budget cut massively
 - Unhelpful in recruiting
- LB&I hit hard: approximately 20% loss of staff
 - Large corporate audit coverage: 9.5% in 2016 -- down from 16.6% in 2010

THINGS THAT ARE UP AT THE IRS

- 7% growth in number of individual returns
- 20% growth in number of LB&I taxpayer returns
- Cyber security, ID theft threats continue to emerge
 - NTEU: 1 million fraudulent returns filed in 2016, attempting to claim \$6.5 billion in refunds
 - Hardware AND software out of date, creating risk
- Large implementation guidance projects pile on (FATCA, ACA, partnership audit rules)
- Threats to employee morale

THINGS THAT ARE UP AT THE IRS (CONT'D)

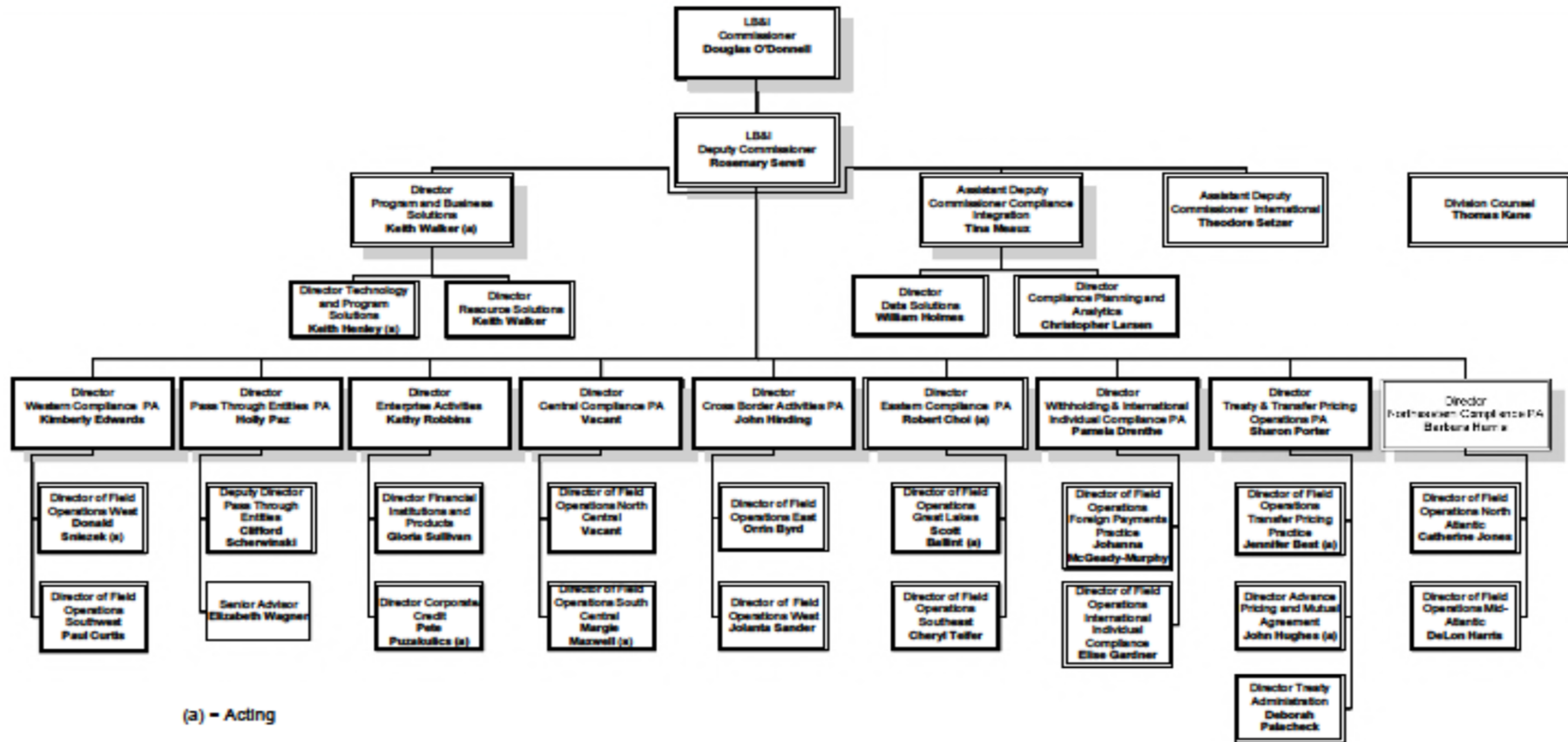
- Resources required to comply with White House regulatory initiatives
 - Currently undertaking review of ALL 2016 regs
 - Announced 4/21/17, have 60 days to assess which ones:
 - Impose an undue financial burden;
 - Add undue complexity; or
 - Exceed the IRS's authority
 - Within 150 days, must report out on specific actions to mitigate the burdens identified
 - Suspend/delay effective date? Modify? Rescind?
- Tax reform???

IRS SAW THE WRITING ON THE WALL

- 2014 “conops” document emerges – LB&I’s “concept of operations”
- Four guiding principles for future state of LB&I:
 - Flexible, well-trained workforce
 - Selection of better work
 - Tailored treatments
 - Integrated feedback loop
- Responses:
 - Restructure org chart
 - Campaigns

FIRST RESPONSE: RESTRUCTURE

LB&I Organizational Chart



NINE PRACTICE AREAS

■ Five substantive areas

- Pass-throughs
- “Enterprise activities” (includes financial products/institutions, corporate issues and credits, and penalties)
- Treaties and transfer pricing
- Withholding and individual compliance (FATCA)
- Cross-border activities

■ Four geographies

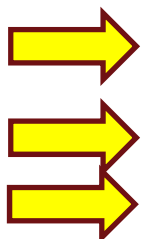
- Northeast
- East
- Central
- West

Plus HQ and support:

1. International
2. Compliance integration
3. Program & business solutions

SECOND RESPONSE: CAMPAIGNS

Campaign	Treatment streams	Practice Area
Section 48 energy credits	Soft letter, issue-based exams	Enterprise activities
OVDP declines/withdrawals	“A variety, including examination”	Withholding/individual compliance
DPAD: Multi-channel video and TV broadcasters	Publication of practice unit, published guidance, issue-based exams	Enterprise activities
Micro-captive insurance	Issue-based exams	Enterprise activities
Related party transactions	Issue-based exams	Enterprise activities
Deferred variable annuity reserves and life insurance reserves	Public guidance	Enterprise activities
Basket transactions	Issue-based exams, practitioner outreach, soft letters	Enterprise activities
Land developers and completed contract method	Practice unit, soft letters, issue-based exams	Enterprise activities
TEFRA linkage plan strategy	Developing new procedures and technology for examiners conducting TEFRA exams	Pass-throughs
S corporation losses claimed in excess of basis	Issue-based exams, soft letters, outreach, new form for computing basis	Pass-throughs
Repatriation	Improve issue selection, “conducting examinations on identified, high risk repatriation issues and thereby increase taxpayer compliance”	Cross-border activities
Form 1120-F non-filers	Soft letters, issue-based exams	Cross-border activities
Inbound distributor	Issue-based exams	Treaties/transfer pricing



INTERNATIONAL-FLAVORED CAMPAIGNS

Repatriation	LB&I is aware of different repatriation structures being used for purposes of tax free repatriation of funds into the U.S. in the mid-market population .* It has also been determined that many of the taxpayers do not properly report repatriations as taxable events on their filed returns. NOTABLE: Doesn't mention "treatment streams" but instead states: "The goal of this campaign is to simultaneously improve issue selection filters while conducting examinations on identified, high risk repatriation issues and thereby increase taxpayer compliance."
Form 1120-F non-filer	Foreign companies doing business in the U.S. are often required to file Form 1120-F. LB&I has data suggesting that many of these companies are not meeting their filing obligations. In this campaign, LB&I will use various external data sources to identify these foreign companies and encourage them to file their required returns.
Inbound distributors	U.S. distributors of goods sourced from foreign-related parties have incurred losses or small profits on U.S. returns, which are not commensurate with the functions performed and risks assumed. In many cases, the U.S. taxpayer would be entitled to higher returns in arms-length transactions.

*mid-market taxpayers informally defined to include non-CIC LB&I taxpayers

COUNTRY-BY-COUNTRY REPORTING: IMPLEMENTATION

OECD and US Updates

CBCR - BACKGROUND

- All OECD and G20 countries committed to implementing CBCR, as described in 2015 report on Action 13
- Considered key element in addressing risks of base-erosion and profit-shifting
- Implementation “due date” for tax years beginning 1/1/2016
 - But not every country ready
 - Many countries (like US) still implementing domestic legislation, regulations, forms, infrastructure

OECD CBCR UPDATE

- April: New update to Action 13 implementation guidance – 3 topics
- I. Addresses technical questions on definition of “revenues” for purposes of €750 million filing threshold
 - Extraordinary income, gains from investment activities are included
 - Financial sector: If financial statements require reporting of net, not gross, then follow that treatment (e.g., interest rate swap)

U.S. regs:

Definition of revenue. For purposes of this section, the term revenue includes all amounts of revenue, including revenue from sales of inventory and property, services, royalties, interest, and premiums. The term revenue does not include payments received from other constituent entities that are treated as dividends in the payor's tax jurisdiction of residence. Distributions and remittances from partnerships and other fiscally transparent entities and permanent establishments that are constituent entities are not considered revenue of the recipient-owner. The term revenue also does not include imputed earnings or deemed dividends received from other constituent entities that are taken into account solely for tax purposes and that otherwise would be included as revenue by a constituent entity. With respect to a constituent entity that is an organization exempt from taxation under section 501(a) because it is an organization described in section 501(c), (d), or section 401(a), a state college or university described in section 511(a)(2)(B), a plan described in section 403(b) or 457(b), an individual retirement plan or annuity as defined in section 7701(a)(37), a qualified tuition program described in section 529, a qualified ABLE program described in section 529A, or a Coverdell education savings account described in section 530, the term revenue includes only revenue that is reflected in unrelated business taxable income as defined in section 512.

OECD CBCR UPDATE, CONT'D

- April update to Action 13 implementation guidance (continued)

2. Addresses how to determine existence/membership of a group (public co: follow consolidation rules that ordinarily apply; private co: more latitude OK)

- Also instructs that revenues of non-wholly-owned subs should be counted towards €750 million filing threshold to the extent accounting rules dictate full or pro-rated inclusion

OECD CBCR UPDATE, CONT'D

- April update to Action 13 implementation guidance (continued)
 3. Addresses “parent surrogate” (voluntary) filing issues
 - Adds three new countries (**highlighted**) to the list of jurisdictions that are willing to accept parent surrogate filings:
 - **Hong Kong, China**
 - **Liechtenstein**
 - **Nigeria**
 - Japan
 - Russia
 - Switzerland
 - U.S.

US CBCR UPDATE

- Draft **Form 8975** issued in January
 - No instructions, still in draft
- **Regs** published last June (T.D. 9773) – under mandatory review
- Rev. Proc outlining **parent surrogate filing** procedure
 - Rev. Proc. 2017-23 (February 2017)
 - Applies to reporting periods for US parent entities beginning on/after 1/1/16 and before the applicability date of Treas. Reg. Sec. 1.6038-4, which is the year of the US parent that begins on/after June 30, 2016
 - IRS ready to accept beginning on 9/1/17
 - If return filed already, must amend
 - Filing amended return for sole purpose of attaching 8975 will not affect statute of limitations
 - E-filing in XML encouraged, software developers to be given instructions “in early 2017”

US CBCR UPDATE, CONT'D

- Bilateral agreements – progress?
 - Countries must exchange CAAs to facilitate exchange of CBCRs
 - 100+ in play, two U.S. models
 - LB&I Commissioner Doug O'Donnell said in March that US expects to conclude CAAs “in a timely manner”
 - Jurisdictions must have an information exchange instrument (or treaty) AND adequate information safeguards
 - Safeguards inadequate? Won't do CAA
 - US businesses looking for lists (concluded? intended?)
 - Concerns about requiring multiple CBCRs (different reporting standards and currencies), need to reconcile, viewed as noncompliant (local business risk)

OTHER US COMPETENT AUTHORITY NEWS

OTHER US CA NEWS...

- CA annual report on APAs – issued on March 27
 - 98 new APA applications filed in 2016
 - Top countries: India (34%), Japan (31%), Canada (8%), Germany (7%), Italy and UK (both 4%). All other countries = 12%
 - 86 APAs executed in 2016 (59% renewals, 41% new APAs)
 - Top countries: Japan (54%), Canada (20%), Korea (6%), Germany (5%), France (4%). All other countries = 11%
 - 398 pending, a “slight drop,” with Japan and Canada accounting for nearly half of them
 - Japan 34%, Canada 14%, India 9%, Germany 8%, Korea, 7%, UK 5%, China 4%. All other countries 19%

OTHER US CA NEWS... (CONT'D)

- OECD's MAP peer review
 - Action 14 – making dispute resolution processes more effective
 - Sets “minimum standards” for countries to ensure they resolve treaty-related disputes in a timely, effective and efficient manner
 - “Terms of reference” translate that minimum standard into 21 elements to evaluate member countries’ legal and administrative framework (complemented by 12 “best practices”)
 - 44 countries to be assessed by the end of 2018

“The key objective ...is to help the jurisdiction identify areas where it can improve to achieve an efficient and effective MAP process.”

OTHER US CA NEWS... (CONT'D)

- MAP peer review – timing, expected outcome (cont'd)
 - Process includes:
 - Self-assessment
 - Assessment by treaty partners, taxpayers
 - Assessed jurisdiction can respond
 - Administrators prepare report, goes through comment, approval, adoption process
 - Post-assessment monitoring (“stage 2 peer monitoring”)
 - US in “first batch,” launched in December 2016
 - Also includes Belgium, Netherlands, Canada, Switzerland, UK
 - Next batch launching this month (Austria, France, Germany, Italy, Liechtenstein, Luxembourg, Sweden)

LITIGATION UPDATE

AMAZON V. COMMISSIONER

148 T.C. No. 8 (MAR. 23, 2017)

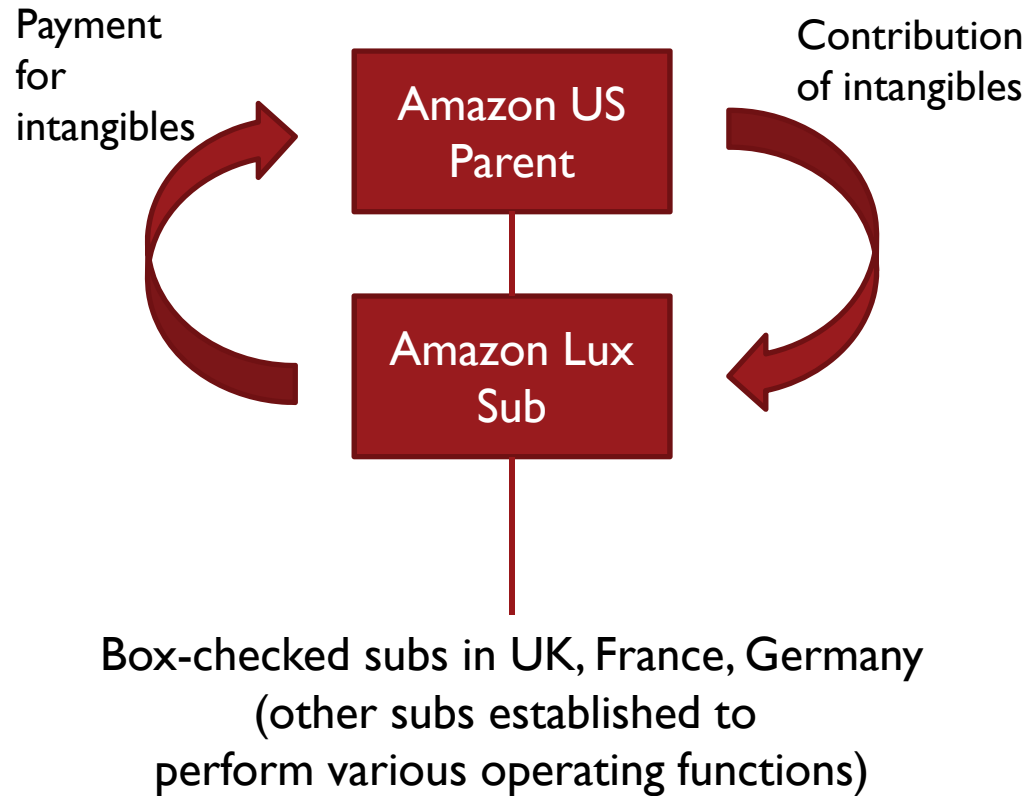
- Dispute over amount of buy-in payment for cost-sharing agreement
- Also in dispute, cost-sharing payments made over time
- Tax Court largely held for taxpayer
- Old cost-sharing regs
- Re-litigating Veritas



AMAZON'S BUSINESS ENVIRONMENT

- In Europe (UK, Germany, France): Local, local, local
 - Local manager for each country
 - Differing cultural preferences, retail traditions, national regulations → differing details of operations, technology
 - Even largest vendors transacted in Europe at local level
 - Pricing local – sensitive to competitors (which were local)
 - Fulfillment practices
 - Payment preferences
- Internet retail, generally
 - Constant innovation req'd to meet customer expectations
 - Website functionality/content, fast fulfillment, timely customer service, safe payment process, data protection, smartphones!

AMAZON'S 'PROJECT GOLDCREST'



- In 2004, Amazon established Lux sub as HQ for European operations (at the time, only UK, Germany, France)
- US transferred website technology, marketing intangibles, European customer lists
- Lux paid US \$255 million
- Ongoing cost-sharing arrangement

AMAZON HOLDING

- IRS: \$255 million? \$3.46 billion, more like
- Taxpayer's comparable uncontrolled transactions method vs. IRS's discounted cash flow
- Court rejected major tenets of IRS's method

MEDTRONIC: ARGUMENTS

- IRS argued to aggregate all related transactions, and that that PR sub performed one function: final manufacturing according to processes approved by the US, NO PR-based nonroutine intangibles.
 - Sum of transactions? US not getting paid enough
- Taxpayer argued that it followed the existing MOU, and that IRS didn't appropriately weigh importance of quality in med device industry
 - PR bore risk of product failure

MEDTRONIC HOLDING

- Tax Court: IRS's actions were arbitrary, capricious, unreasonable
 - IRS's CPM not the only route to “commensurate with income”
 - Refused to follow IRS's aggregation of all transactions (like Amazon)
 - IRS downplayed role of QUALITY, and PR in general
 - Recalls deadly in this industry (to people, to business)
 - PR manufacturer was fully exposed to risk of quality problems
 - PR contributed to design, product development; highly skilled workforce
 - “Comparables” were not comparable

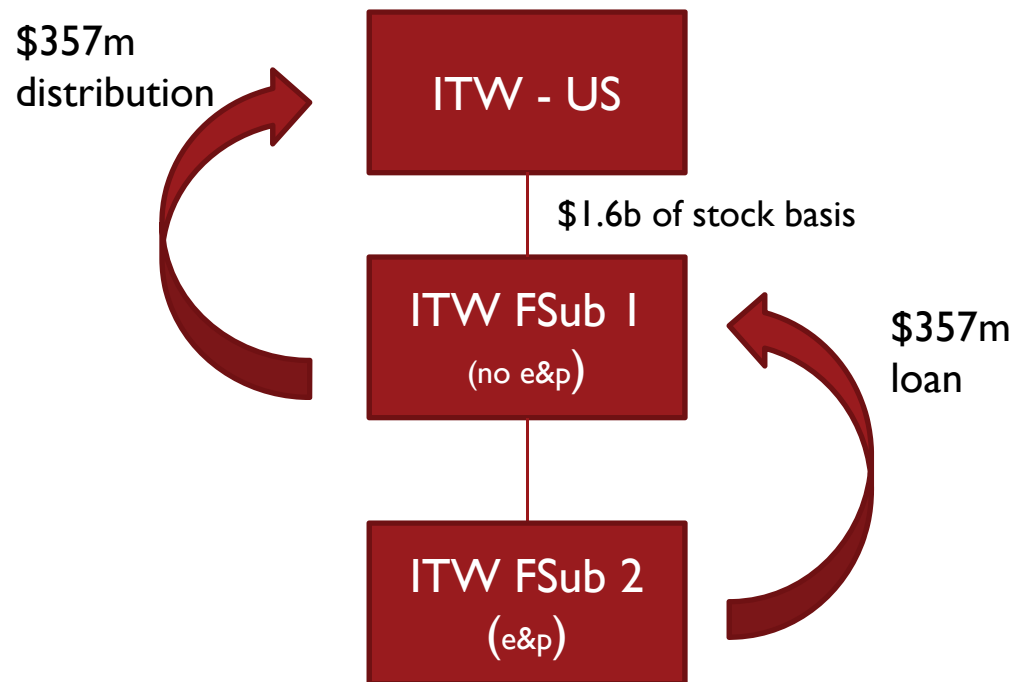
IRS appealing! Filed notice in late April

IL. TOOL WORKS V. COMMISSIONER **(TAX COURT, PENDING)**

- Repatriation transaction, \$357m item at issue, \$70+m asserted deficiency
- Trial concluded in August
- Post-trial briefs filed in December
- Awaiting decision



ITW'S TRANSACTION



- FSub 2 lent \$357m to FSub 1
- FSub 1 distributed \$357m to ITW-US
- IRS argued for dividend from FSub2 to US

IL. TOOL WORKS

- IRS arguments:
 - Loan not true debt, really a dividend
 - Alternative: 956 inclusion (on a conduit theory), FSub 2 lent directly to US
 - Basis was overstated

IL. TOOL WORKS V. COMMISSIONER **(TAX COURT)**

- Characteristics of the debt:
 - Promissory note
 - Fixed interest (6%), actually paid (\$20m/year)
 - Taxpayer had \$618m of cash in year of transaction (2006), but it borrowed about a third of the loan amount from unrelated banks with parent guarantees
- Taxpayer defended form and substance (borrower creditworthiness, coverage ratios, ample access to assets to repay)

IL. TOOL WORKS V. COMMISSIONER (TAX COURT)

- Why watch for outcome?
 - Goes to heart of 385 issue: What is real debt?
 - How much does promissory note (and payments in accordance with its terms) count towards respecting form? Debt coverage ratios? Etc.
 - Will long-standing Falkoff case remain good law when done and over?
 - Falkoff: Seventh Circuit overturned Tax Court, holding that borrowing from bank to fund ROC distribution at end of year one should be respected despite near immediate creation of E&P in distributing company (thanks to prewired sale of property) a day or two into year two
 - Same circuit would likely have jurisdiction on appeal
 - Falkoff v. Commissioner, 604 F.2d 1045 (7th Cir. 1979)
 - Also might be instructive on basis studies; sounds like this one had the usual hair on it

OTHER CASES TO WATCH

■ Zimmer Holdings Inc. v. Commissioner

- Tax Court petition filed in August 2014
- Transfer of intangibles to Dutch sub
- IRS arguing alternatives: 367(d) or CPM under 482
- Also issue of workforce, goodwill transfers (med device)



■ Coca-Cola v. Commissioner

- Tax Court petition filed in December 2015
- IRS claims US parent undercharged foreign affiliates for IP (including trademarks, formulas) related to drink concentrates
- Taxpayer argues that it followed TP rules set forth in a long-standing closing agreement; without explanation, IRS departed from it in favor of the CPM, routine returns based on ROA methodology



OTHER CASES TO WATCH



■ Microsoft

- Long (8-year) audit
- In court because government took summons enforcement actions (W.D.Wash.)
- IRS spent \$2 million on outside legal help
 - Power to issue summons?
 - Confidentiality of taxpayer information?
 - Conflicts?
- Speculation, could be largest proposed TP adjustment ever?

SIDE NOTE #1: BREXIT

U.K. Issues

STAGES IN THE PROCESS

- Article 50 of the Treaty on European Union outlines the process for withdrawal
- UK gave required notification on March 29, 2017
- Kicks off official exit process
 - European Council and UK negotiate terms of exit
 - EU treaty network no longer applies when they conclude the exit agreement or, at the outside, two years after notification
 - Council and UK can together agree to extend two-year period

TAX ISSUES POTENTIALLY IMPACTED

- UK's "department for exiting the European Union" published a paper on [March 30] outlining how European Union law will continue to impact UK law post-Brexit
 - Couple of highlights:
 - On exit, existing EU laws will be converted into UK law, then Parliament can sort things out (overturn, leave, tweak, etc.)
 - UK will keep legislation enacted to implement EU legal principles
- Big question: What will UK be able to negotiate?
 - Easy enough for it to provide favorable treatment, but will that treatment be reciprocal?

TAX ISSUES POTENTIALLY IMPACTED

- Withholding on interest, royalties
- Dividends
- Exit taxes
- Tax-free mergers
- Public CBCR

**SIDE NOTE #2:
PUBLIC TAX POLICY
STATEMENTS**

WHAT IS IT?

- A public tax policy statement is an organization's declaration of its policies and procedures towards all things tax
- Key elements include discussions of:
 - the company's attitude towards tax risk,
 - its use (or nonuse) of tax "havens" and "shelters," and
 - its relationship with tax authorities.

EXAMPLE: HEINEKEN

[HTTP://WWW.THEHEINEKENCOMPANY.COM/SUSTAINABILITY/GOVERNANCE/OUR-APPROACH-TO-TAX](http://www.theheinekencompany.com/sustainability/governance/our-approach-to-tax)



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Our Approach to Tax

The taxes we pay are an important part of our contribution to economies. They help the development of the many countries in which we operate.

We believe that responsible tax behaviour is an essential element of our sustainability strategy. The taxes we pay are an important part of our contribution to local economies and support the development of the many countries in which we operate.

We support stable, transparent and predictable tax regimes that incentivise long-term investment and economic growth. We also support the principles that underpin the OECD's work on Base Erosion and Profit Shifting (BEPS), including country-by-country reporting to tax authorities. HEINEKEN is working to ensure its compliance with the new requirements.

Tax governance

We operate in a high number of tax jurisdictions, some of which have complex tax regimes. Tax legislation can also be subject to interpretation. To ensure a robust and consistent approach, the HEINEKEN Tax Control Framework describes how tax is managed within HEINEKEN, both at a strategic and operational level. It supports tax risk management and ensures adherence to our tax principles, requiring documented policies and procedures across all our operating companies.

Tax strategy

In support of HEINEKEN's business priorities we pursue a tax strategy that is sustainable and transparent. This strategy is annually reviewed and approved both by the Executive Board and the Audit Committee¹.

Our tax strategy is based on a number of key principles:

- Our commitment to comply with relevant tax laws and international regulations goes beyond legal compliance:

WHY HAVE ONE?

- New U.K. requirement
 - Other countries to follow?
- Tax as a sustainability issue
- Increasing media attention on tax
- More critical NGO reports



The best defense may be a good offense

THE WALL STREET JOURNAL

Politics and Policy | FRIENDLY LARGO

Wal-Mart Cuts Taxes By Paying Rent to Itself

Other Retailers, Banks Use Loophole in Rules To Loophole States' Levies

By JESSE DRUCKER
Updated Feb. 1, 2007 12:01 a.m. ET

As the world's biggest retailer, Wal-Mart Stores Inc. pays billions of dollars a year in rent for its stores. Luckily for Wal-Mart, in all 50 states it has been paying most of that rent to itself -- and then deducting that amount from its state taxes.

The strategy is complex, but the bottom line is simple: It has saved Wal-Mart from paying several hundred million dollars in taxes each year, according to court records and a person familiar with the matter. And Wal-Mart is far from alone.





QUESTIONS?

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