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Summaries from The 2020 36th Annual TEI-SJSU High Tech Tax Institute

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Post-Pandemic Tax Practice: Lessons Learned for the High-Tech Sector

By: Charlene Kliatchko, MST Student

The 36th Annual TEI-SJSU High Tech Tax Institute Conference took place on November 9th and 10th, 2020; the first time since its establishment that the conference was held virtually. This was due to the gathering restrictions of the COVID-19 pandemic. The conference featured panels with government representatives, tax practitioners, academic professionals, and industry professionals. The panel that spoke on *Post-Pandemic Tax Practice: Lessons Learned for the High-Tech Sector* addressed the issues and revelations that arose during the pandemic. Panel representatives were Nora Beltran, IRS Western Compliance, Territory Manager; Stephen Dunphy, Vice President of Tax Operations at Ross Stores and President of the TEI Silicon Valley Chapter; Lupita McLane, Chief People Officer at Seiler LLP; Peter Rock, IRS Western Compliance Director of Field Operations; and Jeff Swerdlow, Senior Director at Alvarez & Marsal, LLP.

Challenges for the IRS

The IRS representatives, Nora Beltran and Peter Rock, addressed the difficulties and infrastructure challenges the IRS faced at the start of the pandemic. When the COVID-19 stay at home orders were put in place, it became mandatory for businesses to require all workers to work from home. It required the IRS to switch from working full-time in the office to full-time teleworking. Ms. Beltran explained that the IRS was not ready to have its employees work remotely, which made it extremely problematic to transition to full-time teleworking. She explained that there was significant stress on the IRS system due to the volume of teleworkers using it all at the same time. The IRS had to modify their processes due to the restrictions of the pandemic. All paper files are located in the office and audit sites, but auditors had no access to audit sites. In addition, IRS audits were not as fast to adapt to web access or Zoom, as opposed to, face to face audits. As a result, substantial virtual training and great emphasis on cyber security was required. The IRS learned that although it took a great deal of time and development of processes to convert to full-time teleworking, it allowed schedule flexibility for employees. Mr. Rock went into detail about this which required employees to work the core hours of 9:30 a.m. to 2:30 p.m., but the flexibility to work any other time, up to 10 hours a day, either 4 or 5 days a week.

Challenge for Industries

Mr. Dunphy emphasized how difficult it was to transition the whole company to teleworking. Ross was not fully prepared to have their management and employees work remotely. Employees were not equipped with the resources and technology needed to work from home, so the company had to provide these to their employees. In addition, management also had to build policies on the fly. The stress and workload of preparing the company for teleworking was disruptive to the business. At the start of the pandemic, Ross Stores had to close due to the shelter-in-place orders. Gross receipts decreased by more than 50 percent. Although sales

decreased significantly, the company still wanted to continue to pay their employees. The employees were happy, and the company was allowed a tax credit. Mr. Dunphy discussed the Employee Retention Credit under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which allows the company a credit up to 50 percent on up to \$10,000 of qualified wages paid per employee. This, however, was burdensome for the company to compute. It consumed a lot of their payroll employees' time to gather sales and payroll details to substantiate the requirements for the credit.

Challenge for Tax Practitioners

Mr. Swerdlow mentioned that prior to COVID-19, Alvarez & Marsal, LLP had a meeting about transitioning the firm to teleworking and flex scheduling for employees. However, due to the abrupt restrictions of shelter-in-place orders, Mr. Swerdlow explained that instead of easing into implementing work from home processes, the firm had to work quickly and operate in a fast-paced and frantic style.

Ms. McLane emphasized the significance of creating a successful long-term remote work strategy for the company, and most importantly, for their employees. Ms. McLane described how important it is to keep the company culture alive, even through virtual working. She briefly discussed the effects of teleworking, including high anxiety and loneliness; and the importance of being aware of an employee's well-being. She advised that leaders need to be available for employee support and show compassion during these uncertain times. Ms. McLane emphasized that it is crucial for employers to consider the needs of their employees in order for an organization to succeed.

Mr. Swerdlow discussed the impacts of the changed work requirements. He explained that it is hard to say what will happen after we overcome the pandemic. Mr. Swerdlow mentioned that the population may have different preferences. There will be some people who will want to go back to working in the office, while others will want to continue to telework full-time. Then, there may be some people who want the hybrid model of working, that allows split time between time working in the office and working remotely. Mr. Swerdlow described the practical considerations that need to be put in place if offices begin to open to their employees and the public. Furthermore, he explained that organizations have adapted well so far, and recommends that all should consider the future and think long-term going forward.

Conclusion

The panel of representatives shared the challenges they faced that other establishments can relate to. As a tax and accounting professional, I personally experienced the struggles of transitioning and working from home. It was a surprise to hear that other companies, even large ones, were not already prepared to telework. I learned that it is crucial that organizations establish a work from home culture that will last, and that it is essential to build a system and processes that work best for your business, and especially for employees. Businesses need to

consider what its people need to succeed. Organizations should embrace teleworking and allow employees the flexibility and opportunity to work where they please. It will give businesses the opportunity to empower their workforce in new ways.

Dealing with Losses: CARES Act Changes, Debt Restructuring, and Other Strategies for a Strong Future

By: Jane Lei, CPA, MST Student

The 36th Annual TEI-SJSU High Tech Tax Institute conference featured a panel of four subject matter experts tackling the timely topic of *“Dealing with Losses: CARES Act Changes, Debt Restructuring, and Other Strategies for a Strong Future.”* The panelists included Rob Black, Partner at PwC; Eileen Marshall, Partner at Cooley; Mark Perwien, Senior International Advisor, Enterprise Activities, at the Internal Revenue Service; and Myra Sutanto Shen, Partner at Wilson Sonsini Goodrich & Rosati.

Net Operating Losses - The CARES Act

Mr. Black kicked off the presentation by reviewing the impact of the Coronavirus Aid, Relief, and Economic Security (CARES) Act on tax provisions related to net operating losses (NOLs). To provide economic relief to businesses struggling from the impact of the pandemic, the CARES Act was signed into law in March 2020. Among other things, it amended section 172 to allow a five-year carryback of NOLs from the tax years beginning in 2018, 2019 and 2020. As a result of this change, losses generated during the three-year period from 2018 through 2020 at a 21 percent tax rate can be carried back to the preceding five-year period which was subject to the higher 35 percent tax rate. The CARES Act also temporarily removed the 80 percent taxable income limitation to allow an NOL to fully offset taxable income. The 80 percent limitation will resume after December 31, 2020.

Mr. Black further discussed the impact of the changes to the NOL rules on completed mergers and acquisitions (M&A) transactions. Specifically, corporations that have engaged in M&A transactions since the enactment of the Tax Cuts and Jobs Act (TCJA) should evaluate the potential benefits of carrying back any recent NOLs and should review the transaction agreements to determine how to allocate any tax refunds resulting from the CARES Act provisions between the parties. Ms. Marshall noted that because many companies did not contemplate the applicability of NOL carrybacks after the TCJA and prior to the CARES Act, the companies may have removed such provisions from pre-TCJA agreement templates as they were deemed inapplicable. Ms. Sutanto Shen added, however, that carryback provisions may have still been relevant in certain state and/or foreign jurisdictions, in which cases, agreements may have retained their carryback provisions.

No doubt there are many complexities associated with carrying back an NOL in an acquisition scenario, whether the NOL is generated pre-acquisition or post-acquisition. Depending on the circumstances and mechanics of the transaction, a buyer may have different options at its disposal. For example, the buyer may decide to waive the carryback period and carry forward the NOL. The election to waive the carryback period must be made no later than the timely filed return for the year that includes the NOL, with the exception of NOLs generated in 2018

and 2019, for which the election must be made no later than the timely filing of the 2020 tax return.

In the case of a buyer that is part of a consolidated group that generates a post-acquisition consolidated NOL (CNOL), the group may make an irrevocable election to waive the entire carryback period with respect to the CNOL. In this case, the election would be applicable to the entire group and none of the CNOL may be carried back. An alternative option known as the “split-waiver election” is available, whereby a buyer consolidated group may make an irrevocable election to waive all CNOLs attributable to an acquired company for the portion of the carryback period during which the acquiree was a member of a different consolidated group. A split-waiver election must generally be filed with the buyer consolidated group’s timely filed original return for the year in which the corporation became a member. Because of the amendments to NOL rules from the CARES Act, the IRS issued temporary regulations to effectively allow a buyer consolidated group to file a late amended split-waiver election by November 30, 2020.

Section 382(h)

Next, Ms. Sutanto Shen covered the proposed regulations under section 382. Section 382 imposes limitations on NOL carryforwards and certain built-in losses following an ownership change. The annual limitation is based on the fair market value of the corporation’s stock prior to the ownership change multiplied by the applicable federal long-term tax-exempt rate, which is currently a low 0.89 percent.

If a loss corporation¹ has a net unrealized built-in gain (NUBIG) at the time of the ownership change, then it may increase its section 382 limitations by its recognized built-in gain (RBIG). Conversely, if a loss corporation has net unrealized built-in loss (NUBIL) at the time of the ownership change, then it may decrease its section 382 limitations by its recognized built-in loss (RBIL). NUBIG and NUBIL are calculated by comparing the fair market value of the loss corporation’s assets to its tax basis in those assets at the time of the ownership change.

In 2003, the IRS released Notice 2003-65, which provides two methods for identifying RBIG and RBIL. Under the section 1374 approach, RBIG and RBIL are determined as the amount of gain or loss recognized on the sale of an asset during the recognition period, meaning there would be no increase in the section 382 limitation unless the asset is sold. The second approach under section 338 allows a corporation to determine RBIG and RBIL by comparing actual items of income, gain, deduction and losses with those items that would have resulted from a hypothetical sale of its assets.

In September 2019, the IRS introduced proposed regulations which included a number of changes, most notably eliminating the more favorable section 338 approach and instead

¹ Section 382 defines the term “loss corporation” as a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs.

applying the section 1374 approach with the rationale that the latter is more consistent with the text and purpose of section 382 and simplifies tax administration. Also among the amendments were provisions related to conformity with the TCJA, changes to the treatment of contingent liabilities, deferred deductions and cancellation of debt (COD) income.

Under the 2019 proposed regulations, the final regulations would have been effective on their date of publication. In January 2020, the IRS released additional proposed regulations which provided taxpayers with some relief. Firstly, the new proposed regulations delayed the effective date to 30 days after the publication date of final regulations. Further, corporations that undergo an ownership change may continue to apply Notice 2003-65 through the delayed effective date, or indefinitely for ownership changes after the delayed effective date subject to the following conditions:

- A binding agreement in effect on or before the delayed effective date
- Transaction that has been publicly announced or described in a filing with the Securities and Exchange Commission on or before the delayed effective date
- Bankruptcy court order on or before the delayed effective date
- Transaction that has been described in a private letter ruling request submitted to the IRS on or before the delayed effective date

NOL Poison Pills

Ms. Sutanto Shen also discussed the concept of NOL poison pills, a mechanism to disincentivize acquisitions of significant amounts of stock. NOL poison pills result in significant dilution of both economic and voting interest to the third-party acquirer and are commonly structured as rights provided to stockholders to purchase shares of a company's stock at a discount in a triggering event, for example, the acquisition of 4.99 percent or more of company's stock by a third party without Board approval, or the announcement of a tender or exchange offer that would result in a third party acquiring 4.99 percent or more of company's stock. Such rights are designed to give the company's board an opportunity to consider and respond to an acquisition attempt by a third party that would negatively affect the value of the Company's NOLs.

Ms. Sutanto Shen shared recent market data collected by Wilson Sonsini Goodrich & Rosati. According to the data, 132 companies have implemented NOL poison pills in the past ten years with 72 of these arrangements still in effect today. A comparison of year-over-year data shows that at the beginning of the COVID-19 pandemic, there was a significant increase in the number of companies implementing NOL poison pills; i.e., 25 companies implemented NOL poison pills during the period from March through August of 2020 compared to 11 companies during the same period in 2019. Further, a significant number of transactions involving poison pills can be observed during the March to April 2020 timeframe, which coincides with the March 23, 2020 low of the S&P 500 index.

Section 163(j) Limitation on Business Interest Expense

The next item on the agenda for the panel was the section 163(j) limitation on business interest expense. Under the TCJA, the deductibility of business interest expense for any tax year after December 31, 2017 was limited to:

- 30 percent of adjusted taxable income, plus
- business interest income (BII), plus
- floor plan financing interest for the taxable year

Any amounts disallowed may be carried forward as business interest expense indefinitely. Certain businesses, including “small businesses” with average annual gross receipts of \$26 million or less over the preceding three-year period are exempt from the limitation. The CARES Act made a number of temporary but meaningful changes to section 163(j). Firstly, it increased the limitation to 50 percent of adjusted taxable income for tax years beginning in 2019 and 2020. Taxpayers, however, can elect not to apply the 50 percent limitation in 2019 or 2020 if taking the deduction for those years would increase the taxpayer’s NOL. The utilization of the NOLs would be subject to the 80 percent of taxable income limitation, whereas a disallowed business interest expense carryforward is not subject to such limitation. Rev. Proc. 2020-22 provides guidance on how to make this election. The CARES Act further allowed taxpayers to elect to calculate the 50 percent limit for 2020 based on its adjusted taxable income in 2019, which could provide a bigger deduction for businesses that expect to have a lower taxable income in 2020 due to the impact of the pandemic. Ms. Marshall highlighted that in a section 381 transaction, if an acquiring corporation makes this election, the acquiree company’s 2019 adjusted taxable income is not included in determining the limitation per the proposed regulation. The proposed regulation also included clarifications on situations involving other complexities, for example, an acquiring company and its target company having different tax years.

Final regulations issued in 2020 under section 163(j) included a refined definition of interest, which sets forth four broad categories of items that are treated as interest under section 163(j), including an anti-avoidance rule. The anti-avoidance rule states that any expense or loss “economically equivalent” to interest is treated as interest expense if one of the principal purposes of structuring is to reduce amounts that otherwise would have been treated as interest under the other categories. Ms. Marshall and Mr. Perwien discussed specific provisions of the anti-avoidance rule to highlight the changes brought about by the final regulation.

Conclusion

This article only attempts to touch on some of the presentation's highlights in addressing a topic as broad and complex as the tax treatment of business losses. The recent changes effected by the CARES Act and the inevitably evolving regulatory landscape add to its complexity. In order to seize any available tax savings and cash flow opportunities from business losses, tax professionals will require not only in-depth knowledge of the applicable rules but also a holistic understanding of the taxpayer's unique circumstances.

Post-Election Tax Analysis for High Tech and Beyond

By: Hanna Shatanionak, CPA, MST student

Ray Beeman, Principal and Co-Leader of the Washington Council at Ernst & Young, and former congressional tax staff for the U.S. House Committee on Ways and Means and the Joint Committee on Taxation, was the keynote speaker for the TEI-SJSU High Tech Tax Institute Virtual Conference held in November 2020. In his presentation “Post-Election Tax Analysis for High Tech and Beyond,” Mr. Beeman discussed how the outcome of the U.S. presidential election may shape tax policy. He opened by analyzing the post-election changes in Washington and discussing 2020 Presidential and Senate race highlights. He briefly discussed the first major pieces of legislation recent presidents had enacted after taking office. He also observed that no prior U.S. president was re-elected if there had been a recession within two years before a bid.

Mr. Beeman then shared his 2021 policy outlook and process considerations, including a divided government scenario and potential areas for bipartisan deals. He concluded by addressing issues related to expiring tax provisions in the Tax Cuts and Jobs Act (TCJA) and the international digitization project implemented by the Organization for Economic Co-operation and Development (OECD). At the time of this presentation, the presidential election results had not been finalized. On November 7, 2020, former Vice President Joe Biden was declared the winner of the presidential race, but control of the Senate was still unknown.

Mr. Beeman addressed the common question that many had in mind, whether Congress will consider tax increase as a solution to the huge federal deficit caused by the coronavirus pandemic. The Congressional Budget Office projects a federal budget deficit of \$3.3 trillion in 2020, more than triple the shortfall recorded in 2019 and the \$1.8 trillion projected in 2021.¹ Pre-COVID, the deficit was projected to be \$1 trillion each year. Due to the government response to the pandemic, the debt-to-GDP ratio is projected to exceed the 100% mark 10 years sooner than previously projected. Economists had for years considered the 100% mark to be the ceiling, but many have increased this assessment by 50%, as the bond market has not reacted, and interest rates have remained low. Mr. Beeman confirmed that at this point neither party is showing particular interest in using tax increases to compensate for this debt spike. He is certain that the Republicans would not sign up for tax increases strictly to reduce the deficit and that President Biden’s proposed tax increases were not intended, at least during the campaign, to be enacted as a standalone package but to be combined as revenue sources for his major priorities.

Mr. Beeman discussed scenarios for how certain policy issues could play out under a Democratic or Republican Senate. If Democrats win control of the Senate, major priorities like stimulus, climate change, health care, education, and housing may be passed in the House and Senate, some or all of which might be financed with tax increases. Still, the vote margin will be

¹ Congressional Budget Office, An Update to the Budget and Economic Outlook: 2020-2030, September 2020.

tight, and Democrats would have to negotiate with some Senate Republicans in order to achieve the 60-vote threshold necessary to move most legislation through the Senate. Another option that Democrats most likely would consider is to employ a budget reconciliation process that allows certain legislation to pass with 51 votes. However, each reconciliation bill is limited as it cannot increase the deficit outside the 10-year budget window and has other restrictions as to what can be included in such a bill. Overall, Biden's comprehensive tax plan would add up to about 4 trillion U. S. dollars on the business side, which is an increase of about 2 trillion dollars mainly due to three provisions: an increase in corporate rate to 28%, 15% minimum tax on book income, and the first round of tightening up the GILTI rules. There is also a second round of tightening the GILTI rules as part of Biden's "Made in America" plan to address offshoring.

Types of tax increases that Biden supported during the campaign would not be included as part of initial stimulus legislation but would instead be used to offset the cost of changes in permanent policies. Biden campaigned with a promise that tax increases would not affect individuals earning less than \$400,000 annually. There are indicators that tax increases could be delayed at least until 2022.

Calling Biden's plan "a menu of revenue proposals," Mr. Beeman cautioned against thinking about it as an actual tax plan because it would still have to go through Congress as a standalone tax bill, much like the TCJA. At this point, Biden's plan is a series of proposed sources of revenue to help offset the cost of other non-tax projects that the Biden administration would want to pursue healthcare, housing, climate. President Biden's major tax proposals are unlikely to get through the Senate in the divided government scenario. If Republicans retain Senate control, the Majority Leader Mitch McConnell (R-KY) will decide which bills are brought up in the Senate and can block Democratic priority bills that are financed with tax increases. Mr. Beeman reviewed some of the key measures and ideas President Biden will continue to propose as part of the Treasury Greenbook, and reasons these proposals are not expected to be approved by the Senate. For example, Mr. Beeman does not expect the proposal of 15% minimum tax on book income over \$100 million to be enacted due to the complications that would arise in implementing this change and also due to its impact on financial accounting. Also, any changes favoring the trillions-of-dollars Green New Deal on energy is likely to be dismissed by Republicans. According to Mr. Beeman, Republicans are very committed to maintaining the 21% corporate tax rate and are unlikely to increase it, even with the current economic situation. Also, if the Democrats are not in control of the Senate, Republicans are not going to participate in any legislation that involves raising rates on an individual's top earners for at least the next two years. Many members of the Finance Committee are up for re-election in 2022 and, if the Senate flips, the tax rate increase will be easier for Democrats to achieve.

In his 2021 policy outlook, Mr. Beeman noted that even in a divided government scenario, there are some areas of potential bipartisan deals, such as infrastructure, retirement savings, changes scheduled under the TCJA and health care. Both parties have a strong desire for significant infrastructure investment. The main issue has always been the funding, which

potentially could be solved by Biden's proposal to raise the corporate income tax. Another area of bipartisan support with regard to President Biden's "Made in America" initiative is the incentivizing of domestic production activity. As a result of the pandemic, Biden also has an intense focus on supply chains and offshoring. There are several proposed solutions on the table in Washington, including offshoring tax penalties and tax credits as an incentive for investment and manufacturing in the U.S. Republicans have their own solution, such as tax incentives for onshoring. Nevertheless, there are signs that both parties can work together on these areas.

Mr. Beeman also suggested that legislation could include incentives for research and development, such as an increase in the research tax credit, investment tax credits, and advanced research credits. Both parties may also consider a repeal of the R&D amortization provision, enacted as part of the TCJA but not effective until 2022. So, it is possible that proposals seen as rebuilding the economy and creating jobs without raising taxes could attract support among Republicans in the Senate.

Mr. Beeman also mentioned that Biden and McConnell worked together for many of Biden's 30 years in the Senate. The Obama administration would often send Biden to negotiate deals with McConnell. For example, they negotiated a resolution to the 2012 "fiscal cliff" slate of tax increases. With a divided government scenario, this history may help in areas that have potential for bipartisan consensus. However, a significant challenge for Democrats when attempting to cut a deal is that Republicans have already emphasized that they will focus more on the budget deficit going forward.

The primary focus of the tax committee in the next Congress, especially if Republicans control the Senate, continues to be the TCJA. Mr. Beeman noted that they will be interested in finding a way to make the TCJA permanent or to extend provisions that are expiring. There is also a real interest in looking at some of the delayed effective date provisions and their impact on companies. Congress is planning to apply the experience from the past two years to closely analyze the technical aspect of GILTI and whether it has any unintended consequences. Mr. Beeman did not expect any major changes in the near future but he mentioned that the tax committees had an interest in understanding what changes in GILTI rules would benefit companies. The TCJA was the first draft of international tax reform, which is still a work in progress, particularly with some of the more global OECD shifts on international tax. Mr. Beeman suggested that a fresh interest on the Hill in TCJA refinement is worth paying attention to, even though it wasn't a big part of the campaign. Biden's proposal will affect some factors that would take the GILTI rate up to 21% and subsequently adopt a jurisdiction-by-jurisdiction approach to GILTI, as opposed to the current worldwide basis of GILTI measurement.

Mr. Beeman emphasized that the TCJA has a built-in tax increase that will automatically be triggered by the phase-out of the expensing provisions regardless of inaction in a divided government scenario. He discussed the dynamics of some of the main provisions to consider. First, starting in 2022, the TCJA will require companies to amortize their R&D costs over five

years instead of deducting them immediately each year. This change will increase the cost of investment, which can unfavorably impact R&D and reduce the level of economic output.

Second, after 2021, the measure for 30% limitation on the interest expense deduction will change from Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) to Earnings Before Interest and Taxes (EBIT). According to Mr. Beeman, there is also discussion to extend the temporary 2020 increase in income threshold from 30% to 50% enacted by the congressional CARES Act, which will otherwise expire in 2020. Also, he mentioned that he expects a fair amount of lobbying to delay or repeal these changes in the TCJA. There is already a bipartisan bill in both the House and the Senate to repeal the R&D amortization provision. Mr. Beeman observed that, if any changes are made to the TCJA, the R&D amortization provision has a high chance of being repealed as the government has a strong interest to address it.

Third, at the end of 2025, the whole individual side of TCJA, including Section 199A and the SALT deduction limitation, will expire and make an impact as well. Mr. Beeman does not expect Congress to address all these provisions any time soon, although he suggested that they could end up delaying some of them. He explained that the costs of repealing the conversion to EBIT and the R&D amortization are much more significant than if they were delayed for a couple of years. A delay may result in a 2025 “fiscal cliff” similar to but much more significant than the one that had been set to occur in 2012, because that “fiscal cliff” only involved individual tax rates, while the 2025 “fiscal cliff” would involve tax rates and tax base. Mr. Beeman noted that it is not clear at this point how the government can work out a solution with bipartisan agreement. Despite the nearness of expiration dates, he thinks a solution will not be achieved even in the term of the next president. Most likely, Congress will address all these issues only in the following term.

To conclude, regardless of the outcome of the Georgia Senate runoff election, even if the Democrats are able to take control of the Senate, there will still be progressive and moderate groups within the party. It is unlikely that the government will be able to achieve major changes to the tax code whether Democrats or Republicans control the Senate. Bipartisan deals could be possible in a divided Congress, including potential compromise tax legislation in which Republicans presumably negotiate to keep or fix some of their priorities from the TCJA in exchange for the Democrats’ priorities.

U.S. International Tax Issues and Developments Summary

By: Liubov (Luba) Shilkova, MST Student

The 36th Annual TEI-SJSU High Tech Tax Institute conference held on November 9-10, 2020 via Zoom, was honored to have Jim Fuller once again present on various international tax issues and developments such as the final Global Intangible Low Tax Income (GILTI) regulations, new IRC §163(j) regulations, and final regulations on sale of partnership interests. Mr. Fuller is a partner at Fenwick & West LLP. He has been named one of the world's top 25 tax advisers by *Euromoney* multiple times, most recently in 2019. He is the only U.S. tax adviser to receive a Star Performer rating (higher than first tier) in Chambers USA (2020); Chambers Global ranks him tier one in corporate and international tax (2020). He is also one of the three "most highly regarded" U.S. tax practitioners according to Who's Who Legal (Law & Business Research). *Legal 500* has included Mr. Fuller in its "Halls of Fame" for both Corporate Tax and International Tax. This article summarizes some of Mr. Fuller's points and concerns as it relates to the finalized and new regulations.

Final Regulations: Source of Income from Sales of Property

Mr. Fuller briefly discussed final regulations dealing with the source of income derived from certain sales of personal property. These regulations retain the overall approach of the proposed regulations, with certain revisions.

Under IRC §863(b)(2), income from the sale of inventory produced (in whole or in part) by the taxpayer in the U.S. and sold outside the U.S., or vice-versa, is allocated and apportioned between the U.S. and foreign sources solely based on the production activities with respect to the property.¹ Before the TCJA, IRC §863(b)(2) sourced income from these transactions as partly U.S. and partly foreign but did not specify a method for determining the amount sourced as foreign or U.S. The TCJA amended IRC §863 regarding special rules for determining the source of income, including income partly from within and partly from without the U.S.

Under final Reg. §1.863-3(c)(2)(i) (as redesignated), where the taxpayer's production assets are located both within and outside the U.S., the amount of income from sources outside the U.S. is determined by multiplying all the income attributable to the taxpayer's production activities by a fraction:

- the numerator of the fraction is the average adjusted basis of production assets that are located outside the U.S.
- the denominator is the average adjusted basis of all the production assets located within and outside the U.S.²

¹ Section 863(b)(2).

² Reg. 1.863-3(c)(2)(i).

The final regulations make a noteworthy change to one of the rules under §865(e)(2). The proposed regulations provided that sales of inventory property produced outside the U.S. and sold through an office maintained by a nonresident in the U.S. must be sourced in the U.S. at least in part. Mr. Fuller mentioned that the final regulations generally retain the rules in the proposed regulations and clarified that Reg. §1.865-3 applies only if a nonresident maintains an office or other fixed place of business in the U.S. to which a sale of personal property is attributable. The final regulations also reorder and revise parts of Reg. §1.865-3 in a non-substantive manner.

The proposed regulations provided rules for determining the portion of gross income from sales (sourced in the U.S.) and production activities (sourced according to the rules of §863(b)). Under the proposed rules, the default method would allocate 50 percent of gross income to each category (“50/50 method”), but nonresidents could elect to use their books and records to make the allocation (“books and records method”) if they met certain requirements. The final regulations added additional requirements with respect to the books and records method: an election to apply the books and records method continues until revoked and may not be revoked without IRS consent for any tax year beginning within 48 months of the end of the taxable year in which the election was made. An election, or revocation of an election, to apply the books and records method is made by attaching the required statement to an original timely filed U.S. tax return (including extensions). Therefore, taxpayers should assess whether or not to elect the books and records method given that the final regulations would prevent a taxpayer from revoking such election if the use of the 50/50 method could provide better tax results in that year.

The final regulations also revised Reg. §1.864-5 to clarify the interaction with §865(e)(2) and (3) and the promulgation of Reg. §1.865-3. Gross income, gain, or loss from the sale of personal property treated as from sources within the U.S. under Reg. §1.865-3 will generally be effectively connected with the conduct of a trade or business in the U.S. to the extent provided in §864(c), other than §864(c)(4) or (5).

Final Regulations: Foreign Tax Credits and Related Matters

There were some changes made by the TCJA which impacted the foreign tax credit and some related areas. Despite the fact that certain provisions in the foreign tax credit and expense allocation rules that were proposed in December 2019 along with rules addressing certain hybrid issues that were proposed in April 2020 were adopted by the final regulations without substantive change, there are areas where the final regulations clarify or depart from the proposed regulations. These areas include the allocation and apportionment of stewardship expenses, the allocation and apportionment of research and experimental (R&E) deductions, and foreign tax redeterminations. The final regulations also revised guidance on adjustments to hybrid deduction accounts, conduit financing arrangements, and branch loss and dual consolidated loss recapture rules.

Stewardship Expenses

The 2019 proposed regulations provided that stewardship expenses are to be allocated to inclusions under §951 and §951A, §78 gross-up dividends, and amounts included under the passive foreign investment company regime, in addition to dividends received or to be received. The proposed rule specified that stewardship expenses are considered definitely related and allocable to “dividends and inclusions received or accrued, or to be received or accrued” from a related corporation (as opposed to “dividends received, or to be received” under the previous regulations). In addition, the proposed regulations provided that, once allocated, stewardship expenses are apportioned based upon the relative values of a taxpayer’s stock assets, in the same manner as used for apportioning interest.

The final regulations revised the proposed rules and make important clarifications in certain areas. The pre-existing definition of stewardship expenses as a “duplicative activity” or activities that preserve a shareholder’s capital investment or facilitate compliance with reporting, regulatory, or legal requirements remains the same. Also, the final regulations provided that stewardship expenses incurred with regard to oversight of “business entities” (i.e. disregarded entities, partnerships, and corporations) are subject to allocation and apportionment rules.³ However, the rules do not extend the definition of stewardship expenses to include oversight expenses incurred with respect to an unincorporated branch of the taxpayer, since the branch’s income is income of the taxpayer itself, not income of a separate entity in which the taxpayer is protecting its investment.

The final regulations provide that stewardship expenses can be allocated and apportioned to income and assets of all affiliated and consolidated group members, and that the affiliated group rules in Reg. §1.861-14 are not applied for purposes of allocating and apportioning stewardship expenses.⁴ Stewardship expenses incurred by one member of an affiliated group to oversee the activities of another member are allocated and apportioned by the investor taxpayer on a separate entity basis, with reference to the investor’s stock in the affiliated member. Also, for purposes of determining the value of an entity, the final regulations provide that the value of the stock in an affiliated corporation is characterized as if the corporation were not affiliated.⁵ In addition, the stock is characterized by the taxpayer in the same ratios in which the affiliate’s assets are characterized for purposes of allocating and apportioning the group’s interest expense.

Since stewardship activities are not fungible, the final regulations provide that, at the allocation step (but before applying the apportionment rules), only the gross income which is derived from entities to which the taxpayer’s stewardship expense has a factual connection is included.⁶ The regulations also provide a guidance in other areas, including guidance on

³ Reg. 1.861-8(e)(4)(ii)(A).

⁴ Id.

⁵ Reg. 1.861-8(e)(4)(ii)(C).

⁶ Reg. 1.861-8(e)(4)(ii)(B).

determining the tax book value of a taxpayer's investment in a disregarded entity, clarification that the exempt income and asset rules do not apply for purposes of apportioning stewardship expenses, and specific guidance on the application of the other rules.

This article summarizes only some of Mr. Fuller's wide range of international tax topics and developments. While the IRS and Treasury issue clear technical guidance, many areas of the international tax law are subject to additional interpretations by tax practitioners. Also, it is important to be aware of all changes in international tax law in order provide clients with professional advice and help them build appropriate tax strategies.

Hold the Date

37th Annual TEI-SJSU High Tech Tax Institute
November 8 and 9, 2021

Expected live in Palo Alto with a virtual option too.

<https://www.sjsu.edu/taxinstitute/>

Research Tax Credit

By: Xiaoyue Tan, MST student

The research tax credit (R&D credit), which is provided for increasing research activities, can benefit taxpayers suffering from the coronavirus pandemic. However, some companies lack knowledge about the research tax credit.

A panel of five tax experts provided an update on the research credit at the High-Tech Tax Institute held on November 9 and 10, 2020. They are Matt Normington, Partner at Deloitte; Travis Riley, Partner at Moss Adams; Dan Mennel, Partner at Grant Thornton; Michael Washburn, Large Business and International (LB&I) Office of Chief Counsel at the Internal Revenue Service (IRS); and Cheryl Teifer, Director of Field Operation, Eastern Compliance Practice Area at the IRS.

The panel analyzed recent court cases involving research tax credit issues in the LB&I Division's compliance campaign, state R&D tax credit updates, and the impact of the Tax Cuts and Jobs Act (TCJA).

What is the R&D Credit?

The R&D credit allows businesses to claim a credit based on a percentage of qualified research expenses during the taxable year. Qualify activity involves technological experimentation used in the development of a new or improved business. The research must significantly enhance a new or improved function, performance, reliability, or quality. Qualified research is divided into in-house research and contract research. In-house research includes taxable wages for employees who perform or directly supervise or support qualified activities, and cost of supplies used in qualified activities. Qualified research includes 65% of contract research expenses that are attribute to qualified activities, and rental costs of computers used in qualified activities. Certain activities are excluded. For example, software designed primarily for internal use, and not for qualified research or a production process, does not qualify as research activity. Research in the social sciences, arts, or humanities; research funded by any grant, contract, or otherwise by another person; and research conducted outside the United States do not qualify as research activity.¹

If companies incur qualified research expenses during the taxable year, they can claim research credit equal to the sum of 20 percent of the excess qualified research expenses over the base amount, 20 percent of the basic research payments, and 20 percent of the amounts paid or incurred to an energy research consortium for energy research.

Recent Court Cases

¹ IRC § 41(b) - Credit for increasing research activities

Mr. Washburn first discussed recent research credit opinions that came out from District court, Tax court, and California office of Appeals cases. He emphasized that the research credit has variety elements that require diverse set of evidence. It is important for taxpayers to think through what support documents they need case by case.

The government claimed that the taxpayer could not meet the burden of proof because the taxpayer calculated the fixed base using start-up company rule, however, the taxpayer could not demonstrate it was a start-up company. *United States v. Quebe*, Dkt. No. 3:15-cv-294 (S.D. Ohio Jan. 17, 2019), 2019 WL 250602 (granting Government's MSJ and holding that taxpayer failed to prove it qualified to calculate credits using I.R.C. § 41(c)(3)(B) applicable to start-up companies).

Siemer Milling Co. v. Commissioner, T.C. Memo. 2019-37 (taxpayer failed to prove it conducted qualified research on certain business components by failing to establish that it satisfied the process of experimentation requirement with respect to any of its projects; in addition, taxpayer failed to establish that some of its projects met the section 174, business component, and/or technological information tests).

Swat-Fame, Inc. 2020-OTA-046P (March 22, 2019) (Cal.Off.Tax App.), 2019 WL 9050584 (taxpayer failed to prove substantially all of its activities were part of a process of experimentation for a qualified purpose; among other things, it did not prove it conducted methodical processes of experimentation rather than simple trial and error).

Order, Populous Holdings v. Commissioner, (T.C. Dkt. No. 405-17) (Dec. 6, 2019) (granting taxpayer's MSJ and holding that research was not funded as (1) taxpayer bore financial risk of research's failure under fixed-price contracts and (2) taxpayer retained substantial rights as there were no provisions that prevented it from using the research or that required it to pay to do so).

Audio Technica v. United States, 963 F.3d 569 (6th Cir. 2020) (government not barred by settlements of prior year claims from arguing fixed-base percentage was incorrect).

LB&I Compliance Campaign

LB&I compliance campaigns were launched on January 31, 2017. One of the purposes of LB&I is to address significant compliance risk. Mr. Washburn analyzed some cases about compliance issue of research tax credit in recent years. In *Siemer Milling Co. v. Commissioner*, T.C. Memo. 2019-37, taxpayer failed to prove it conducted qualified research on certain business components by failing to establish that it satisfied the process of experimentation requirement with respect to any of its projects. In *United States v. Quebe*, 123 AFTR 2d 2019-543, taxpayer failed to prove it qualified to calculate credits using IRC §41(c)(3)(B) applicable to start-up companies. These court cases reflect high compliance risk about research issues. On February 27, 2020, the IRS announced a new LB&I compliance campaign, Research Issues.

Mrs. Teifer, the Director of Field Operations Engineering of LB&I Organization, explained that the research issues campaign (RIC) will address issues involving the research credit and research and experimental expenditures under IRC §41 and IRC §174, which are some of the most prevalent LB&I tax issues that utilize significant examination and taxpayer resources. The campaign will employ various treatment streams, including issue-based examinations, form updates, and requests for guidance. The goals of the RIC are to conduct issue-based examinations using filtering techniques to identify high-risk returns; to promote consistency of examinations and voluntary compliance through proper issue development; and, based on information gathered from examinations, to request additional guidance and/or form updates to assist with reporting and auditing of research issues.

State R&D Tax Credit Updates

Some states also offer the R&D tax credit. They generally comply with federal regulations and IRS guidance, but some of them do not. For example, the R&D credit rate in California is 15 percent, as opposed to the federal rate of 20 percent with the regular calculation method. Another difference is that unused California research credits can be carried forward indefinitely, unlike federal credits, which can be carried back one year and carried forward twenty years. Mr. Normington provided the following updates for the R&D tax credit in each state.

Arizona

- Credit rate tiers set to decrease for tax years ending on or after 12/31/2030:
 - <\$2.5M Incremental qualified research expenses (QREs) = 24% vs 20%
 - >\$2.5M Incremental QREs = \$600K + 15% vs \$500K + 11%

Louisiana

- Sunset date extended to 12/31/2025 (was 12/31/2021)

Maryland

- Online application due no later than 11/15/2020
- Funding cap applies (typically 10% - 11% of requested amount)
- Approval certificate must be received by 2/15/2021
- Because certificate comes after return is filed, taxpayers may either amend or utilize the credit in any of the 7 taxable years after the taxable year that generated the credit
- Certificate must be attached to the return when utilized
- This is helpful for taxpayers who do not want to amend

New Jersey

- Mandatory combined filing requirement
- Method used for federal and New Jersey must be consistent (i.e., if use ASC for federal it must be used for New Jersey)

North Dakota

- For tax years 2019 and after, a taxpayer may elect to use the ASC method
- Credit equals 17.5% of the first \$100K incremental credits + 5.6% of the amount >\$100K
- \$2M credit cap

Ohio

- Increasing audit activity
- Requirement to compute credit on calendar year basis (complexity for fiscal year taxpayers)

Texas

- Increasing audit activity
- Major focus on auditing on a project-by-project basis
- Limited flexibility with respect to project documentation (i.e., must prove 100% of all R&D projects meet 4-part test, regardless of materiality)
- Software, especially internal use software, continues to be an area of focus for exam

Impact of the TCJA

Before the TCJA, R&D expenses could be deducted immediately or charged to a capital account for no less than five years. However, starting in 2022, companies will not be able to immediately expense research costs. Instead, they will be required to charge US-based research expenses to a capital account and deduct them over a five-year period, or a fifteen-year period for research performed outside of the United States. Therefore, time value analysis should be performed to assess how much the value of credits may have reduced. Intense lobbying to eliminate or prolong this provision is expected in the coming years.

Under the TCJA, the maximum tax rate was decreased to 21 percent, and net credit was made equal to 79 percent of gross credit instead of 65 percent. The lower corporate tax rate has led to increased credits, which has benefited taxpayers.

Corporate taxpayers' alternative minimum tax rate of 20 percent was repealed by the TCJA. Individual exemptions and phase-outs for alternative minimum tax was increased from the \$200,000 to \$500,000 range. As a result, corporate and individual taxpayers have been able to use more of their research credit currently rather than having to carry it forward.

Conclusion

Taxpayers should consult their tax advisors to make the greatest use of federal and state R&D tax provision. Most states offer a research tax credit and most adopt rules similar to those of the federal R&D credit. State credits are even more generous than the federal credit in some cases. Some states require taxpayers to file an application other than tax return. The amortization period for foreign research expenditures (15 years) is longer than for United States-based research expenditures (5 years). It is important for taxpayers to re-consider the

location of future R&D activities once this TCJA change goes into effect. Taxpayers would benefit from tracking R&D tax credit updates and planning accordingly. Taxpayers also need to be careful about the risk of claiming the R&D credit. It is possible the IRS would examine and disallow some or all the R&D credits. A penalty may occur if the credit was either claimed through negligence or results in a substantial understatement of income tax.

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MST Student Authors for the Winter MST journal edition
(and Professor Nellen)

